TAX TREATMENT OF INTEREST PAID TO FOREIGN PERSONS

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

H.R. 3025 and H.R. 4029

MAY 1, 1984

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TAX TREATMENT OF INTEREST PAID TO FOREIGN PERSONS

TUESDAY, MAY 1, 1984

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met at 10:07 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearing and the texts of H.R. 3025 and H.R. 4029 follow:]

[Press release of Tuesday, Mar. 13, 1984]

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, Announces a Public Hearing on Tax Treatment of Interest Paid to Foreign Persons

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, announces a public hearing to be held Wednesday, April 11, 1984, on proposals to exempt from U.S. tax interest paid to foreign persons. The hearing will begin at 10:00 a.m. in 1100 Longworth House Office Building, the Committee's main hearing room.

Under present law, a U.S. withholding tax of 30 percent is generally imposed on annuities, interest, dividends, rents, royalties, and similar payments by U.S. persons to foreign investors if the payments are not effectively connected with a U.S. trade or business conducted by the foreign investor. Exemptions from the withholding tax are provided in certain situations. In addition, U.S. tax treaties generally reduce or eliminate the withholding tax on interest paid to treaty country residents.

H.R. 3025, introduced by Messrs. Gibbons, Conable, Matsui, Frenzel, Thomas of California, et al., generally would repeal the 30-percent withholding tax on interest paid to foreign investors on portfolio indebtedness. H.R. 4029, introduced by Congressman Doug Barnard, would repeal the tax on interest payments from debt issued by certain private parties only (*e.g.,* Eurobond offerings). The hearings will focus on these legislative proposals and other alternatives to the 30-percent tax which may assist domestic borrowing needs without damaging other aspects of the U.S. economy or increasing tax noncompliance.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard in writing no later than Monday, April 2, 1984, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

In view of the limited time available to hear witnesses, the Committee will not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance will be encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Committee are required to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

Requests to be heard must contain the following information:

1. The name, full address, and capacity in which the witness will appear, as well as a telephone number where he or his designated representative may be reached;
2. A list of any clients or persons, or any organization for whom the witness appears; and
3. A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the printed record of the hearing.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Friday, April 27, 1984, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the hearing begins.

I

98TH CONGRESS
1ST SESSION

H. R. 3025

To amend the Internal Revenue Code of 1954 to repeal the 30 per centum tax on interest received by foreigners on certain portfolio debt investments which operates as a tariff to prevent such investments from entering the United States.

IN THE HOUSE OF REPRESENTATIVES

MAY 17, 1983

Mr. GIBBONS (for himself and Mr. CONABLE) introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to repeal the 30 per centum tax on interest received by foreigners on certain portfolio debt investments which operates as a tariff to prevent such investments from entering the United States.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TREATMENT OF CERTAIN INTEREST.

(a) IN GENERAL.—Subsection (a) of section 871 of the Internal Revenue Code of 1954 (relating to tax on nonresident alien individuals) is amended by adding at the end thereof the following new paragraph:

"(3) INCOME OF NONRESIDENT ALIEN INDIVIDUALS RECEIVED FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—No tax shall be imposed under subsection (a)(1) on interest (including original issue discount) received by a nonresident alien individual if—

"(A) the interest is paid on an obligation which resulted from the assumption after the date of enactment of this Act by a domestic corporation of an obligation which was issued on or prior to such date and which when issued, was guaranteed by a domestic corporation and was sold, directly or through underwriters, under arrangements reasonably designed to ensure that such obligation would be sold only to a person who was not a United States person, or

"(B) the interest is paid outside of the United States on an obligation which, when issued, was sold, directly or through underwriters, under arrangements reasonably designed to ensure that such obligation would be sold only to a person who was not a United States person, or

"(C) the interest is paid on an obligation which is not in bearer form, the United States person who would otherwise be required to deduct and withhold tax from such interest under section

1441(a) has received a statement that the beneficial owner of the obligation is not a United States person and such statement meets the requirements of subsection (g),

but in the case of interest paid on an obligation described in subparagraph (B) or (C) only if (i) in the case of interest received from a corporation, the nonresident alien individual does not own, and is not considered as owning (within the meaning of subsection (h)), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation, or (ii) in the case of interest received from a partnership, the nonresident alien individual does not own and is not considered as owning (within the meaning of subsection (h)), 10 percent or more of the capital or profits interest in such partnership."

(b) CERTAIN STATEMENTS; CONSTRUCTIVE OWNERSHIP.—Section 871 of such Code (relating to tax on nonresident aliens) is amended by redesignating subsection (g) as subsection (i) and by adding after subsection (f) the following two new subsections:

"(g) CERTAIN STATEMENTS.—A statement with respect to the ownership of an obligation shall meet the requirements of this subsection is such statement represents that it is from the beneficial owner of the obligation or such statement is from a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its business, and within the period ending 1 month prior to the payment of interest the Secretary has not published a determination to the effect that statements from such securities clearing organization bank, or other financial institution, or any class of such persons, may not be accepted for the purposes of this subsection.

"(h) Constructive Ownership.—Section 318(a) (relating to the constructive ownership of stock), other than paragraph (1) thereof, shall apply for the purposes of determining ownership of stock of a corporation under subsection (a)(3) and section 881(c), and similar rules shall apply for the purposes of determining ownership of an interest in a partnership under subsection (a)(3) and section 881(c). For the purposes of the preceding sentence, section 318(a)(2)(C) shall be applied without regard to the 50-percent limitation contained therein, and stock of a corporation or an interest in a partnership owned by a person by reason of the application of section 318(a)(4) shall not, for the purposes of applying paragraphs (2) and (3) of section 318(a), be considered as actually owned by such person."

(c) Conforming Amendment.—Section 871(a)(1) of such Code is amended by striking out "There" and inserting in lieu thereof "Except as provided in paragraph (3), there".

SEC. 2. FOREIGN CORPORATIONS.

(a) IN GENERAL.—Section 881 of the Internal Revenue Code of 1954 (relating to tax on income of foreign corporations) is amended by redesignating subsection (c) as subsection (d) and by adding after subsection (b) the following new subsection:

"(c) INCOME OF FOREIGN CORPORATIONS RECEIVED FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—No tax shall be imposed under subsection (a) on interest (including original issue discount) received by a foreign corporation if—

"(1) the interest is paid on an obligation described in section 871(a)(3)(A), or

"(2) the interest is paid on an obligation described in section 871(a)(3)(B), or

"(3) the interest is paid on an obligation which is in registered form, the person who would otherwise be required to deduct and withhold tax from such interest under section 1442(a) has received a statement that the beneficial owner of the obligation is not a United States person, and such statement meets the requirements of section 871(g),

but in the case of interest paid on an obligation described in subsection (2) or (3) only if (i) the interest is not interest received by a controlled foreign corporation, (ii) except for interest paid on an obligation of the United States, the interest is not interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its banking business, (iii) in the case of interest received from a corporation, the corporation receiving the interest does not own, and is not considered as owning (within the meaning of section 871(h)), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation, and (iv) in the case of interest received from a partnership, the corporation receiving the interest does not own, and is not considered as owning (within the meaning of section 871(h)), 10 percent or more of the capital or the profits interest in such partnership."

(b) CONFORMING AMENDMENT.—Section 881(a) of the Internal Revenue Code of 1954 (relating to imposition of tax) is amended by striking out "There" and inserting in lieu thereof "Except as provided in subsection (c), there".

SEC. 3. AMENDMENT OF SECTION 864(c)(2).

Section 864(c)(2) of the Internal Revenue Code of 1954 (relating to effectively connected income) is amended—

(a) by striking out "section 871(a)(1) or section 881(a)"; and

(b) by inserting "section 871(a)(1), section 871(a)(3), section 881(a) or section 881(c)".

SEC. 4. REMOVAL OF EXEMPTION FROM TAX IN CASE OF INADEQUATE EXCHANGE OF INFORMATION.

(a) Subpart C of part II of subchapter N of chapter 1 of the Internal Revenue Code of 1954 (relating to miscellaneous provisions) is amended by adding at the end thereof the following new section:

"SEC. 898. REMOVAL OF EXEMPTION FROM TAX IN CASE OF INADEQUATE EXCHANGE OF INFORMATION.

"Whenever the Secretary determines that the exchange of information between the United States and a foreign country is inadequate to prevent evasion of the United States income tax by United States persons, the exemption from tax contained in section 871(a)(3) and section 881(c) shall not apply to any payment or payments addressed to or for the account of persons within such foreign country after the date specified in the Secretary's determination. Any such removal shall not apply to interest on obligations issued on or before the date of publication of such determination. The removal of the exemption from tax contained in section 871(a)(3) and section 881(c) shall continue until the Secretary determines that the exchange of information between the United States and the foreign country of such information is adequate to prevent the evasion of the United States income tax by United States persons."

(b) The table of sections for such subpart C is amended by adding at the end thereof the following new item:

"Sec. 898. Removal of exemption from tax in case of inadequate exchange of information."

SEC. 5. AMENDMENT OF SECTION 2105.

Subsection (b) of section 2105 of the Internal Revenue Code of 1954 (relating to property without the United States) is amended to read as follows:

"(b) BANK DEPOSITS AND CERTAIN OTHER DEBT OBLIGATIONS.—For purposes of this subchapter—

"(1) amounts described in section 861(c), if any interest thereon would be treated by reason of section 861(a)(1)(A) as income from sources without the United States were such interest received by the decedent at the time of his death,

"(2) deposits with a foreign branch of a domestic corporation or domestic partnership, if such branch is engaged in the commercial banking business, and

"(3) debt obligations, if, without regard to whether a statement meeting the requirements of section 871(g) has been received, any interest thereon would be eligible for the exemption from tax under section 871(a)(3) were such interest received by the decedent at the time of his death.

shall not be deemed property within the United States."

SEC. 6. WITHHOLDING.

(a) NONRESIDENT ALIENS.—Subsection (c) of section 1441 of the Internal Revenue Code of 1954 (relating to withholding of tax on nonresident alien individuals) is amended by adding at the end thereof the following new paragraph:

"(9) INCOME EXEMPT FROM TAX.—No deduction or withholding shall be required in the case of interest (including original issue discount) described in subparagraph (A), (B), or (C) of section 871(a)(3) unless the person otherwise required to deduct and withhold shall know, or have reason to know, that such item of income is not exempt from tax because of clause (i) or (ii) of section 871(a)(3)."

(b) FOREIGN CORPORATIONS.—The last sentence of section 1442(a) of such Code is amended—

(1) by striking out "and" after "section 881(a)(4),"; and

(2) by inserting ", and the reference in section 1441(c)(9) to clauses (i) and (ii) of section 871(a)(3) shall be treated as referring to clauses (ii), (iii), and (iv) of section 881(c)" after "section 881(a)(3)".

SEC. 7. EFFECTIVE DATE.

(a) The amendments made by this Act (other than section (5)) shall apply to amounts paid after the date of enactment of this Act.

(b) The amendment made by section 5 shall apply to the estates of decedents dying after the date of the enactment of this Act.

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98TH CONGRESS
1ST SESSION

H. R. 4029

To amend the Internal Revenue Code of 1954 to provide that interest on "Eurobonds" sold outside the United States will not be subject to the 30-percent tax on interest received by foreign persons.

IN THE HOUSE OF REPRESENTATIVES

SEPTEMBER 29, 1983

Mr. BARNARD introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to provide that interest on "Eurobonds" sold outside the United States will not be subject to the 30-percent tax on interest received by foreign persons.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TREATMENT OF CERTAIN INTEREST.

(a) IN GENERAL.—Subsection (a) of section 871 of the Internal Revenue Code of 1954 (relating to tax on nonresident alien individuals) is amended by adding at the end thereof the following new paragraph:

"(4) INCOME OF NONRESIDENT ALIEN INDIVIDUALS RECEIVED FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—No tax shall be imposed under subsection (a)(1) on interest (including original issue discount) received by a nonresident alien individual if—

"(A) the interest is paid on an obligation which resulted from the assumption after the date of enactment of this paragraph by a domestic corporation of an obligation which was issued on or before such date and which, when issued, was guaranteed by a domestic corporation and was sold, directly or through underwriters, under arrangements reasonably designed to ensure that such obligation would be sold only to a person who was not a United States person, or

"(B) the interest is paid outside of the United States on an obligation which, when issued, was sold, directly or through underwriters, under arrangements reasonably designed to ensure that such obligation would be sold only to a person who was not a United States person,

but in the case of interest paid on an obligation described in subparagraph (B) only if (i) in the case of interest received from a corporation, the nonresident alien individual does not own, and is not considered as owning (within the meaning of subsection (g)), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such such corporation, or (ii) in the case of interest received from a partnership, the nonresident alien individual does not own and is not considered as owning (within the meaning of subsection (g)), 10 percent or more of the capital or profits interest in such partnership."

(b) CONSTRUCTIVE OWNERSHIP.—Section 871 of such Code (relating to tax on nonresident aliens) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) CONSTRUCTIVE OWNERSHIP.—Section 318(a) (relating to the constructive ownership of stock), other than paragraph (1) thereof, shall apply for the purposes of determining ownership of stock of a corporation under subsection (a)(4) and section 881(c), and similar rules shall apply for the purposes of determining ownership of an interest in a partnership under subsection (a)(4) and section 881(c). For the purposes of the preceding sentence, section 318(a)(2)(C) shall be applied without regard to the 50-percent limitation contained therein, and stock of a corporation or an interest in a partnership owned by a person by reason of the application of section 318(a)(4) shall not, for the purposes of applying paragraphs (2) and (3) of section 318(a), be considered as actually owned by such person."

(c) CONFORMING AMENDMENT.—Section 871(a)(1) of such Code is amended by striking out "There" and inserting in lieu thereof "Except as provided in paragraph (4), there".

SEC. 2 FOREIGN CORPORATIONS.

(a) IN GENERAL.—Section 881 of the Internal Revenue Code of 1954 (relating to tax on income of foreign corporations) is amended by redesignating subsection (c) as subsection (d) and by adding after subsection (b) the following new subsection:

"(c) INCOME OF FOREIGN CORPORATIONS RECEIVED FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—No tax shall be imposed under subsection (a) on interest (including original issue discount) received by a foreign corporation if—

"(1) the interest is paid on an obligation described in section 871(a)(4)(A), or

"(2) the interest is paid on an obligation described in section 871(a)(4)(B),

but in the case of interest paid on an obligation described in paragraph (2) only if (A) the interest is not interest received by a controlled foreign corporation, (B) except for interest paid on an obligation of the United States, the interest is not interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its banking business, (C) in the case of interest received from a corporation, the corporation receiving the interest does not own, and is not considered as owning (within the meaning of section 871(g)), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation, and (D) in the case of interest received from a partnership, the corporation receiving the interest does not own, and is not considered as owning (within the meaning of section 871(g)), 10 percent or more of the capital or the profits interest in such partnership."

(b) CONFORMING AMENDMENT.—Section 881(a) of the Internal Revenue Code of 1954 (relating to imposition of tax) is amended by striking out "There" and inserting in lieu thereof "Except as provided in subsection (c), there".

SEC. 3. AMENDMENT OF SECTION 864(c)(2).

Section 864(c)(2) of the Internal Revenue Code of 1954 (relating to effectively connected income) is amended—

(1) by striking out "section 871(a)(1) or section 881(a)"; and

(2) by inserting "section 871(a)(1), section 871(a)(4), section 881(a) or section 881(c)".

SEC. 4. REMOVAL OF EXEMPTION FROM TAX IN CASE OF INADEQUATE EXCHANGE OF INFORMATION.

(a) Subpart C of part II of subchapter N of chapter 1 of the Internal Revenue Code of 1954 (relating to miscellaneous provisions) is amended by adding at the end thereof the following new section:

"SEC. 898. REMOVAL OF EXEMPTION FROM TAX IN CASE OF INADEQUATE EXCHANGE OF INFORMATION.

"Whenever the Secretary determines that the exchange of information between the United States and a foreign country is inadequate to prevent evasion of the United States income tax by United States persons, the exemption from tax contained in section 871(a)(4) and section 881(c) shall not apply to any payment or payments addressed to or for the account of persons within such foreign country after the date specified in the Secretary's determination. Any such removal shall not apply to interest on obligations issued on or before the date of publication of such determination. The removal of the exemption from tax contained in section 871(a)(4) and section 881(c) shall continue until the Secretary determines that the exchange of information between the United States and the foreign country of such information is adequate to prevent the evasion of the United States income tax by United States persons."

(b) The table of sections for such subpart C is amended by adding at the end thereof the following new item:

"Sec. 898. Removal of exemption from tax in case of inadequate exchange of information."

SEC. 5. AMENDMENT OF SECTION 2105.

Subsection (b) of section 2105 of the Internal Revenue Code of 1954 (relating to property without the United States) is amended to read as follows:

"(b) BANK DEPOSITS AND CERTAIN OTHER DEBT OBLIGATIONS.—For purposes of this subchapter—

"(1) amounts described in section 861(c), if any interest thereon would be treated by reason of section 861(a)(1)(A) as income from sources without the United States were such interest received by the decedent at the time of his death,

"(2) deposits with a foreign branch of a domestic corporation or domestic partnership, if such branch is engaged in the commercial banking business, and

"(3) debt obligations, if any interest thereon would be eligible for the exemption from tax under section 871(a)(4) were such interest received by the decedent at the time of his death.

shall not be deemed property within the United States."

SEC. 6. WITHHOLDING.

(a) NONRESIDENT ALIENS.—Subsection (c) of section 1441 of the Internal Revenue Code of 1954 (relating to withholding of tax on nonresident alien individuals) is amended by adding at the end thereof the following new paragraph:

"(9) INCOME EXEMPT FROM TAX.—No deduction or withholding shall be required in the case of interest (including original issue discount) described in subparagraph (A) or (B) of section 871(a)(4) unless the person otherwise required to deduct and withhold shall know, or have reason to know, that such item of income is not exempt from tax because of clause (i) or (ii) of section 871(a)(4)."

(b) FOREIGN CORPORATIONS.—The last sentence of section 1442(a) of such Code is amended—

(1) by striking out "and" after "section 881(a)(4),"; and

(2) by inserting ", and the reference in section 1441(c)(9) to clauses (i) and (ii) of section 871(a)(4) shall be treated as referring to subparagraphs (B), (C), and (D) of section 881(c)" after "section 881(a)(3)".

SEC. 7. EFFECTIVE DATE.

(a) The amendments made by this Act (other than section (5)) shall apply to amounts paid after the date of the enactment of this Act.

(b) The amendment made by section 5 shall apply to the estates of decedents dying after the date of the enactment of this Act.

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Chairman ROSTENKOWSKI. The committee will come to order.

The Committee on Ways and Means will receive testimony on legislation to modify the present 30-percent withholding tax on U.S. sources of income received by a nonresident alien or foreign corporation. Our colleagues, Congressmen Long, Gibbons, and Conable, have introduced H.R. 3025, which would repeal the withholding tax on certain interest paid to foreign investors.

Another of our colleagues, Mr. Barnard, has introduced H.R. 4029, which would repeal the tax on a more limited category of interest. In addition, the Senate-approved Deficit Reduction Act of 1984 would phase out the 30-percent withholding tax on interest over 4 years.

There are several concerns that I hope witnesses will address today. First, what revenue or equity considerations are associated with the complete repeal of the 30-percent withholding tax? In addition, we would appreciate witnesses' views on the likely impact of reducing the tax to a low level, say 3 percent, in lieu of total elimination.

Second, what impact would repeal have on capital flows in the United States and what would be the implication of such flows on the strength of the dollar and on U.S. exports?

A third concern is the likely impact on corporate financing costs if the U.S. Treasury is given direct access to Eurodollar markets and thus can compete with corporate issues.

Also, it is important that the committee understand the implications of present law and any modifications upon potential international tax avoidance or evasion. The committee is aware that provisions contained in both the House- and Senate-approved deficit reduction proposals would affect the tax treatment of international financial subsidiaries. That legislation is premised on the desire to end the use of unintended devices that allow taxpayers to avoid U.S. tax on income and consequently to erode the tax base. I hope that any modification that the committee might consider with regard to the taxation of these interest payments would address the same principle.

In addition, the committee will want to focus on the impact on the Netherlands Antilles of a tax repeal or reduction in conjunction with resourcing and recharacterization provisions. Should we, and if so how might we, ease the transition to a new tax regime?

The issue of the proper tax treatment of interest payments to nonresidents is a difficult one. There are many complex and often conflicting arguments for making a change in present law. I hope today's testimony will assist us in discovering the results which can best achieve the majority of our goals.

[By subsequent unanimous consent, the prepared opening statement of Mr. Conable follows:]

STATEMENT OF HON. BARBER B. CONABLE, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

I would like to commend the Chairman for holding today's hearings on this very important issue concerning the extent to which the 30% withholding tax on U.S. source interest investment income received by non-resident aliens or foreign corporations should be reduced or eliminated. H.R. 3025, the bill cosponsored by myself and Mr. Gibbons would eliminate the 30% rate. Other proposals to reduce the rate gradually and/or selectively have been offered. In analyzing the importance of this legislation, I think one of the primary concerns we should focus on is the impact which eliminating the 30% rate would have on encouraging foreign investors to keep capital invested in the United States both for the short-term and the long-term. I believe that this source of capital should not be discounted. I must admit that the issue of 30% repeal does raise a number of complex issues including the impact on capital formation, the impact on employment and trade balance, the effect on our ability to control our money supply, and certain compliance and revenue issues just to name a few. I certainly hope that today's testimony provides us with some guidance as to the importance of these issues in analyzing the merits of 30% repeal. In particular, I would hope that today's panelists would comment on the extent to which the reduction of the 30% rate will cause companies with existing Euro-dollars offering to bring that debt back to the United States and thus avoid the revenue loss which is currently attributable to Euro-dollar offerings as a result of foreign tax credits being claimed by Euro-dollar issuers.

In focusing on this issue, I would hope that the panelist would be specific as to the extent to which a reduction of the 30% rate is necessary to permit this repatriation of debt, that is, will a reduction to a 2% rate be sufficient to cause companies to bring the debt home, or is it necessary to reduce the rate all the way to zero.

I look forward to the testimony of today's witnesses. Thank you Mr. Chairman.

Chairman ROSTENKOWSKI. Our first witnesses today are: the Honorable Thomas J. Healey, Assistant Secretary for Domestic Finance; and the Honorable Ron Pearlman, Deputy Assistant Secretary for Tax Policy, representing the Department of Treasury. Gentlemen, welcome to the committee. If you are ready to proceed, the committee is ready to receive your testimony.

STATEMENT OF HON. RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. PEARLMAN. Thank you and good morning, Mr. Chairman. First I would like to introduce to the committee my colleague, Tom Healey. Mr. Healey is Assistant Secretary of the Treasury for Domestic Finance, and in that capacity he oversees the management of the public debt. Following my remarks, he will make an oral statement reflecting the Treasury's views from a debt management perspective.

I am pleased to be here this morning to present the views of the Treasury Department on H.R. 3025, which generally would repeal the 30-percent tax on interest paid to foreign investors on portfolio indebtedness, and on H.R. 4029, which also would repeal the 30 percent tax on those interest payments, but only with respect to certain targeted obligations.

I welcome the opportunity to express again to the committee this administration's support for the repeal of the 30-percent tax.

Mr. GIBBONS. Say that again? I did not hear it quite.

Mr. PEARLMAN. I am here to again express this administration's support of the repeal of the 30-percent tax, as proposed in Messrs. Gibbons' and Conable's bill, H.R. 3025.

Mr. GIBBONS. Good. You are coming the right way.

Mr. PEARLMAN. The administration believes that markets function best on a fully competitive basis and that artificial barriers which prevent equal access to foreign capital markets should be removed. We believe that efficient capital markets are an important element in achieving both increased capital formation and sustained economic growth in the United States.

Access to foreign capital in such markets requires that interest on borrowed funds be available free of source country taxation.

Repeal of the 30-percent tax on interest would assist U.S. issuers to compete directly for foreign capital without resort to complex financing structures designed to avoid the 30-percent tax.

The administration believes that direct access to foreign capital markets should be available to all borrowers. Since 1921, foreign persons have been exempt from U.S. tax on interest on deposits with U.S. banks, savings and loans, and other similar financial institutions.

We believe this exemption is appropriate. However, we also believe that other borrowers, including the U.S. Treasury, should not be restricted to borrowing foreign capital either through banks or other financial intermediaries, or by the backdoor route of utilizing international financial subsidiaries.

We are aware that there has been some speculation that repeal of the 30-percent tax on interest paid to foreign persons would lead to an increased level of tax evasion by U.S. persons. Since the enactment of TEFRA we have developed procedures aimed at ensuring that bearer obligations issued by U.S. corporations are targeted only to foreign markets. To the extent any such obligations find their way back into the United States, they would be subject to information reporting.

We believe these procedures are working well as they apply to obligations issued by international finance subsidiaries and would work equally well with respect to obligations issued directly by U.S. borrowers should the withholding tax be repealed.

The bills before this committee today reflect alternative options for permitting direct access by certain U.S. borrowers to foreign capital markets. Both H.R. 3025 and H.R. 4029 are designed to allow such access by certain U.S. borrowers on a tax-free basis.

For reasons that I will discuss at greater length in the course of my testimony, the administration strongly supports the approach of H.R. 3025, which generally would provide equal treatment to all borrowers, over the approach of H.R. 4029, which we understand is intended to restrict the repeal of the tax to more limited categories of Eurobond indebtedness of corporations that could presently borrow in the Eurobond market.

As you are aware, Mr. Chairman, the Senate amendment to H.R. 2163 would repeal 30 percent withholding, but would do it on a phased out basis under provisions that otherwise are similar to H.R. 3025. We support the Senate proposal, although we prefer an immediate repeal of the withholding tax.

I would like to focus now on——

Mr. GIBBONS. I am sorry. What did you say about immediate repeal?

Mr. PEARLMAN. Mr. Gibbons, we are in favor of immediate repeal of the withholding tax over the Senate approach, which is to phase out the repeal.

Chairman ROSTENKOWSKI. Would you speak more clearly, so Mr. Gibbons can understand you?

Mr. GIBBONS. Especially when you get to those favorable points.

Mr. PEARLMAN. Yes.

I would like to now review with the committee the three categories of investment that are made in U.S. portfolio obligations and then focus specifically on one of those. Those three categories are:

obligations issued by U.S. corporations or by the U.S. Government; deposits with U.S. banks or other financial institutions; and obligations issued directly by U.S. corporations through international finance subsidiaries.

I'd like to focus on the third of those categories, namely obligations of international finance subsidiaries, which are debt obligations issued directly in the Eurobond market by U.S. corporations through their international finance subsidiaries. These obligations generally are issued only by large corporate issuers.

The Eurobond market is essentially a network of underwriters or financial institutions that market bonds issued by private corporations, foreign governments and their agencies, and other borrowers. The purchasers of the bonds include both individuals and institutions, such as banks, investment companies, insurance companies, and pension funds.

A well-developed secondary market exists for bonds issued in the Eurobond market. But to permit active trading in that market, the bonds generally are in bearer form and are free from taxes withheld at the source. Because the bonds are typically in bearer form, an investor receives interest and principal by presenting the coupons or the bonds to a designated paying agent.

The structure most frequently used by U.S. corporations to issue bonds in the Eurobond market involves the use of an international finance subsidiary incorporated in the Netherlands Antilles. The ultimate U.S. corporate borrower contributes an amount of capital to the subsidiary in the range of approximately one-half to one-third of the debt the subsidiary plans to issue.

The subsidiary then issues the bonds in bearer form in either a public underwriting or a private placement. In order to avoid registering the bonds with the U.S. Securities and Exchange Commission, the subsidiary issues the bonds pursuant to a so-called lockup procedure, designed to ensure that the bonds are distributed upon issuance only to foreign persons.

In accordance with the lockup procedure, the underwriters covenant not to sell the bonds to U.S. persons and the bonds are delivered upon issuance to the ultimate purchasers only upon receipt of a certificate that the purchaser is not a U.S. person or is not purchasing on behalf of a U.S. person.

The bonds issued by the international finance subsidiary often are traded actively in the secondary market and are listed on foreign exchanges. The U.S. parent or other U.S. affiliate of the international finance subsidiary typically guarantees the obligations of the subsidiary to its foreign investors, and the subsidiary in most cases relends the proceeds of its borrowing to the parent or other affiliate at a slightly higher rate of interest than it pays on its own bonds.

The Netherlands Antilles imposes a 24- to 30-percent tax on the amount that it considers to be the spread between these 2 rates and on the earnings from the equity of the subsidiary.

The U.S. tax consequences of employing the international finance subsidiary structure to gain access to the Eurodollar market are not settled. Several Internal Revenue Service audits have raised the issue of whether certain benefits under our income tax treaty with the Netherlands Antilles actually are available to the international finance subsidiary, and this issue has not been resolved.

However, for purposes of our discussion this morning, assuming that the desired tax consequences are obtained from use of the finance subsidiary structure, then interest on the bonds issued by the subsidiary is free from both United States and Netherlands Antilles withholding taxes. Also, applying the treaty, the finance subsidiary is similarly exempt from the 30-percent U.S. withholding tax.

The net effect of these provisions is that the ultimate U.S. borrower is able indirectly to issue bonds in the Eurobond market that bear interest that is free from all withholding tax. Assuming the structure is respected for U.S. tax purposes, the U.S. parent is able to claim a foreign tax credit for the Antilles tax.

The tax compliance provisions relating to obligations issued in the Eurobond market differ from those applicable to obligations issued directly by U.S. corporations or those applicable to bank deposits. If the interest on the obligations issued by the international finance subsidiary is paid outside the United States, no information reporting is required, regardless of the identity of the recipient. Consequently, a foreign paying agent to whom a coupon is presented is not required to obtain a form W-8 from the payee nor to obtain any other evidence that the payee is a foreign person in order to avoid reporting the interest payment to the Internal Revenue Service.

Although information reporting is not generally applicable to interest paid on finance subsidiary obligations issued in the Eurobond market, provisions were enacted under TEFRA to ensure that such obligations are held only by foreign persons. Under these provisions, sanctions are generally imposed on issuers of obligations in bearer, as opposed to registered, form.

However, in recognition that the foreign capital market is largely a bearer market, Congress provided certain exceptions pursuant to which U.S. bearer obligations could be issued in the Eurobond market without subjecting the issuer to statutory sanctions.

Now I would like to focus on the two bills pending before the committee for consideration and make comments more specifically directed to those two bills. Under H.R. 3025, interest paid to foreign persons on three different categories of obligations would be exempt from the 30-percent withholding tax.

The first exempt category is for interest paid by a U.S. corporation with respect to a debt obligation assumed by that corporation which when issued was guaranteed by a U.S. corporation and was sold under arrangements designed to ensure that the debt would not be sold to U.S. persons. This exemption generally would allow U.S. parents or affiliates of the international finance subsidiaries to assume obligations of those subsidiaries without subjecting the interest paid to the 30-percent withholding tax.

The second exemption is for interest paid outside the United States on obligations, whether issued in bearer or in registered form, that when issued were sold under arrangements designed to ensure that the obligations were not sold to U.S. persons.

This exemption would apply to interest on obligations that are sold under the same foreign targeting procedures now employed to ensure that issuers of Eurobond obligations are not subject to the statutory sanctions for issuing those obligations enacted in TEFRA. For instance, interest would be exempt under this provision on obligations issued in foreign markets in accordance with the typical lockup procedures now employed in issuing obligations through international finance subsidiaries.

As in the case of present obligations issued by international finance subsidiaries, bearer obligations issued directly by U.S. corporations under this exemption could not be held by U.S. persons without such persons being subject to the statutory holder sanctions.

The third exempt category under H.R. 3025 is that for interest paid on registered obligations in cases in which the payor has received a certificate stating that the beneficial owner is not a U.S. person. Because of the certificate requirement, we anticipate that this third exemption would be useful primarily for those foreign persons who wish to purchase registered obligations in the domestic U.S. market, but do not have the anonymity concerns that apparently prevail in the Eurobond market.

Interest otherwise falling within one of the three categories of exempt interest under H.R. 3025 would generally not be exempt if the recipient owned at least 10 percent of the voting power of the issuer, if it is a corporation, or 10 percent of its capital or profits if the issuer is a partnership.

Interest similarly would not be exempt if it were received by a controlled corporation or if it were received by a bank pursuant to loan agreement entered into in the ordinary course of its trade or business. In addition, the Secretary would be given authority to deny the exemption in any situation in which persons resident in a country which it is determined by the Secretary does not exchange sufficient tax information with the United States to prevent the evasion of tax by U.S. persons.

The Senate-passed amendment to H.R. 2163 differs from H.R. 3025 in that it provides a gradual phaseout of the 30-percent tax with respect to the three categories of interest covered by H.R. 3025. Specifically, under the Senate bill the rate of tax on interest received during 1984 and after the date of enactment would be 5 percent, and thereafter the rate would be reduced annually by 1 percent until the tax is fully eliminated on July 1, 1988.

H.R. 4029 differs from H.R. 3025 and the Senate amendment in that it would eliminate the 30-percent withholding tax only with respect to interest on obligations of international finance subsidiaries that are assumed by a U.S. parent or affiliate and obligations that are issued pursuant to measures designed to ensure that they are not sold to U.S. persons.

Thus, the withholding tax would still apply to foreigners who purchase securities in a regular Treasury auction. All U.S. issuers that did not target obligations specifically to foreign capital markets likewise would be denied the benefit of the exemption.

Although as drafted H.R. 4029 does not appear to distinguish between public and private borrowers, we understand from conversations with Congressman Barnard and his staff that it would be his intent to modify the bill to limit the exemption from the 30-percent tax to cover only interest on obligations of those types of issuers that have typically participated in the Eurobond market through international finance subsidiaries.

Therefore, it is our understanding that the provisions of H.R. 4029 are not intended to allow the U.S. Treasury to issue obligations in the Eurobond market free of withholding tax.

As I stated at the outset, the administration believes that access to foreign capital markets is beneficial and that we should remove artificial barriers which prevent equal access to these markets. We believe that the more efficient capital market that will result will contribute to increased capital formation and sustained economic growth in the United States.

Accordingly, we support H.R. 3025, which would improve such access through elimination of the 30-percent withholding tax on interest paid to foreign persons with respect to portfolio indebtedness.

Access to foreign markets should be ensured on a nondiscriminatory, as well as an efficient, basis. Consequently, we believe that the distinction made under current law between banks and similar financial institutions, which can borrow foreign capital directly, and other issuers which must borrow such funds indirectly through foreign intermediaries or offshore finance subsidiaries is unjustified.

Consistent with our position that corporate issuers as well as financial institutions should have direct access to foreign capital markets, we believe that direct access also should extend to the U.S. Government and its agencies. The Treasury Department is effectively precluded from tapping the Eurobond market directly because of the foreign withholding tax.

Consequently, the current situation is that U.S. corporations can issue bonds to the foreign segment of the worldwide market for dollar-denominated securities with a tax advantage over Treasury securities. We find this situation unjustified.

We understand that some people argue that U.S. Treasury securities should not be included in a removal of the foreign withholding tax. It is true that if Treasury securities were exempt from the withholding tax, as they would be under H.R. 3025, then some foreigners would undoubtedly shift from Eurobond corporate securities into Treasury's. This shifting could cause some increase in interest costs from what they otherwise would be for those large corporate issuers which currently have access to the Eurobond market.

But we cannot accept the argument that Treasury and thus the general taxpayer should pay more so that some U.S. corporations may pay less. Allowing foreigners greater access to U.S. Treasury securities by removing the barrier of the withholding tax should reduce Treasury's debt service costs from what they otherwise would be. Treasury's and the American taxpayer's claim on this potential benefit should not be subordinate to any other sector's claim, and legislation repealing the withholding tax should include Treasury securities.

Accordingly, we strongly favor H.R. 3025. We oppose any proposal that would treat Treasury or any other Government obligations differently from corporate issuers in the scope of the repeal of the 30-percent withholding tax.

The provisions of both H.R. 3025 and H.R. 4029 are carefully structured to provide access to the Eurobond market in a simple, straightforward manner, while guarding against the possible use of these provisions by U.S. persons to evade U.S. taxes. In this regard, it must be recognized that the possibility currently exists that U.S. persons may hold interest-bearing obligations outside the United States and may effectively evade U.S. tax.

We would note, however, that neither H.R. 3025 or H.R. 4029 would decrease the protections against abuse or evasion that currently apply with respect to obligations issued through international finance subsidiaries. In either case, the requirements of current law that I have described require that certain procedures be followed to ensure that bearer obligations be targeted to foreign markets and apply sanctions to U.S. persons who hold those obligations.

These procedures are well designed to provide the maximum protection against possible evasion, while not interrupting the normal flow of economic transactions. We will, of course, continue our surveillance of general compliance issues associated with participation of U.S. persons in international financial markets, and we are pleased to consider suggestions of the committee and work with the committee in regard to improving and maintaining that compliance.

The projected revenue impact of H.R. 3025 and H.R. 4029 respectively is summarized in tables attached to my written statement. As indicated in the table, the Treasury Department now estimates that the enactment of H.R. 3025 almost will be revenue-neutral during the fiscal years 1984 through 1987.

If the foreign tax credit antiabuse provisions of H.R. 4170 are assumed to be in force, there will be a revenue gain of about $23 million. In the absence of these provisions, there will be a revenue loss of about $16 million.

If all these provisions are considered as a single package, which is the Treasury's view, there would be a 3-year net revenue gain to the Treasury of about $415 million. These estimates do not take into account any collateral effects, such as lower interest costs to the U.S. Government, which may result from the legislation.

Because the revenue estimates are based on a complex series of assumptions, it may be useful to outline briefly the steps involved in making the estimates and describe the kinds of assumptions that have to be made. One component is the projected amount of revenue that would be withheld in the absence of a repeal. This is based on data of actual collections in 1982, combined with projections of the growth in interest payments after 1982.

Estimates of the amount of obligations held by persons not within the scope of the proposed repeal, including foreign banks and related persons, was also based on a sample from actual collections in 1982.

The most difficult part of the estimating process was determining what percentage of the outstanding Eurobond issues would be assumed by U.S. parent corporations of international finance subsidiaries. This is important because of the savings to the Treasury of U.S. taxes against which credits for foreign tax would otherwise be taken.

A related question is whether any new issues would continue to be made through international finance subsidiaries. In either case, the Treasury has attempted to evaluate all of the information available on the issue and has made conservative assumptions on the amount of foreign tax credit saved. Since almost all financings are made through the Netherlands Antilles, we used the Netherlands Antilles finance subsidiaries as the model for doing our revenue estimates.

I would like to emphasize that the Treasury's support of repeal of the 30 percent withholding tax on interest has never depended on whether there was a revenue gain or a revenue loss, but instead on the desire to end the discriminatory and inefficient system and for further integration of world capital markets.

The Treasury Department strongly supports H.R. 3025 and we look forward to working with the committee to work for its inclusion in the conference on H.R. 4170.

Mr. Chairman, I would like now to turn the microphone to Mr. Healey, after which we will be happy to try to answer your questions.

[The prepared statement follows:]

STATEMENT OF RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Committee, I would like to introduce my colleague, Thomas Healey, Assistant Secretary of the Treasury for Domestic Finance. Secretary Healey oversees the management of the public debt. He will make an oral statement following my remarks, reflecting Treasury's views from a debt management perspective.

I am pleased to present the views of the Treasury Department on H.R. 3025, which generally would repeal the 30 percent tax on interest paid to foreign investors on portfolio indebtedness, and H.R. 4029, which also would repeal the 30 percent tax on those interest payments but only with respect to portfolio indebtedness issued to foreign persons under procedures targeting the issue for foreign markets. I welcome this opportunity to express again to the Committee this Administration's support for repeal of the 30 percent tax, as proposed in H.R. 3025.

This Administration believes that markets function best on a fully competitive basis and that artificial barriers which prevent equal access to foreign capital markets should be removed. We believe that efficient capital markets are an important element in achieving both increased capital formation and sustained economic growth in the United States. Access to foreign capital in such markets requires that interest on borrowed funds be available free of source-country taxation. Repeal of the 30 percent tax on interest would assist U.S. issuers to compete directly for foreign capital without resort to complex financing structures designed to avoid the 30 percent tax.

This Administration believes that direct access to foreign capital markets should be available to all borrowers. Congress has historically endorsed a policy to allow certain categories of U.S. borrowers to compete for foreign capital on a tax-free basis. Most notably, since 1921 foreign persons have been exempt from U.S. tax on interest on deposits with U.S banks, savings and loan institutions and similar financial institutions. As I will discuss more extensively later in my testimony, we believe that this exemption is appropriate. However, we also believe that other borrowers, including the U.S. Treasury, should not be restricted to borrowing foreign capital either through banks or other financial intermediaries or by the "backdoor" route of utilizing international finance subsidiaries.

We are aware that there has been some speculation that repeal of the 30 percent tax on interest paid to foreign persons would lead to an increased level of tax evasion by U.S. persons. Since enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), we have developed procedures aimed at ensuring that bearer obligations issued by U.S. corporations are targeted only to foreign markets. To the extent any such obligations find their way back into the United States, they will be subject to information reporting. We believe that these procedures are working well as they apply to obligations issued by international finance subsidiaries and would work equally well with respect to obligations issued directly by U.S. borrowers, should the withholding tax be repealed. We also believe that, with slight modifications, the procedures in H.R. 3025 will ensure that owners of registered obligations are foreign persons.

The bills before us today reflect alternative options for permitting direct access by certain U.S. borrowers to foreign capital markets. Both H.R. 3025 and H.R. 4029 are designed to allow such access by certain U.S. borrowers on a tax-free basis. For reasons that I will discuss at greater length in the course of my testimony, this Administration strongly favors the approach of H.R. 3025, which generally would provide equal treatment to all borrowers, over the approach of H.R. 4029, which we understand is intended to restrict the repeal of the tax to more limited categories of Eurobond indebtness of corporations that could presently borrow in the Eurobond market.

As you are aware, the Senate amendment to H.R. 2163 includes a phase-out of the 30 percent tax under provisions that are othewise similar to those of H.R. 3025. We support the Senate proposal although we perfer an immediate repeal of the withholding tax.

In the remainder of my testimony I will address in greater detail current law and practices relating to foreign investment in U.S. portfolio indebtedness and discuss the relevant policy, economic and revenue aspects of H.R. 3025 and H.R. 4029.

CURRENT LAW AND PRACTICES

My discussion of current law and practices relating to foreign investment in U.S. portfolio indebtedness focuses on tax and related compliance rules applicable to three broad categories of investments—obligations issued directly by U.S. corporations or by the U.S. Government; deposits with U.S. banks and similar institutions; and obligations issued indirectly by U.S. corporations through international finance subsidiaries.

U.S. Government or corporate obligation.—Interest on obligations issued directly by the U.S. Government or by U.S. corporations is generally subject to U.S. tax at a rate of 30 percent of the gross payment. The tax, which is commonly referred to as a "withholding tax," is required to be withheld at the source, and the amount withheld generally represents the final U.S. tax liability of the foreign investor.

There are various statutory exceptions to the 30 percent tax on interest.[1] The most significant exception in terms of volume is that for interest paid on deposits with domestic banks, savings and loan associations or similar financial institutions.

In addition to the statautory exemptions from the withholding tax, provisions of our income tax treaties also generally eliminate or reduce the withholding tax on a reciprocal basis.[2] In order to secure a treaty exemption from, or reduction of, U.S. withholding tax a foreign investor must provide the withholding agent with a Form 1001, which indicates the identity and address of the investor and represents that he is entitled to treaty benefits. In the case of a bearer bond, the Form 1001 must be provided with each interest payment.

Generally, a payor of interest on U.S. corporate or Treasury obligations is required to file an information return with the Internal Revenue Service on a Form 1099. The Form 1099 identifies the recipient, indicates his taxpayer identification number, and indicates the amount of interest received. However, no Form 1099 is required in the case of interest paid on these obligations to foreign investors, provided that the payor has withheld the 30 percent tax or has received a Form 1001 (indicating a reduced treaty rate) from the investor.

Deposits with banks and similar financial institutions.—The second broad category of U.S. interest-bearing investments available to foreign persons is deposits with

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[1] These exceptions include the following: original issue discount on obligations with maturities of 6 months or less; interest paid on certain debt obligations in an issue with respect to which an election under the expired interest equalization tax was made; interest paid by U.S. corporations that earn less than 20 percent of their gross income from source within the United States; interest paid to foreign governments that is not related to their commercial activities, if any, within the United States; and amounts paid by an insurance company under an agreement to pay interest.

[2] The current U.S. negotiating position, reflected in Article 11 of the U.S. Model Income Tax Treaty, is to seek a reciprocal exemption from tax on interest. Interest is generally exempt under sixteen U.S. income tax treaties currently in force, including those with the Netherlands, the Netherlands Antilles and the United Kingdom. (As discussed below, these exemptions are not sufficient to ensure free marketability of Eurobonds.) Twelve other treaties provide for reductions in the rate of the tax. For instance, the rates of tax on interest paid to residents of Canada, Switzerland are, respectively, 15 percent and five percent.

U.S. banks and similar financial institutions. By characterizing interest paid on deposits of foreign persons with U.S. or foreign branches of financial institutions, including affiliates of foreign institutions, as foreign source income, the Internal Revenue Code essentially exempts such interest from the 30 percent withhodling tax.

The exemption for bank deposit interest reflects the need to maintain the international competitiveness of U.S. financial institutions. To impose U.S. tax on interest paid to foreign persons by U.S. banks would reduce the ability of U.S. financial institutions to compete for foreign funds and would seriously erode the efficiency of the international capital markets.

The rules with respect to information reporting of bank deposit interest are similar to those that apply to interest paid on U.S. corporate or Treasury obligations. That is, interest on deposits with U.S. financial institutions generally must be reported to the Internal Revenue Service on a Form 1099 unless paid to a foreign person. Regulations issued under TARRA provide procedures that must be implemented by banks in distinguishing between their U.S. and foreign customers for purposes of determining whether information reporting is necessary.

Under present law a U.S. branch of a bank is permitted to exempt from reporting interest paid to a customer who purports to be a foreign person only if the customer provides the bank with an IRS Form W-8 (or similar form designed by the bank). On this form the customer must certify, under penalties of perjury, that he is neither a citizen nor a resident of the United States. If a bank pays interest to a person in the United States and it does not obtain either the Form W-8 or a correct taxpayer identification number from the customer, then it generally must withhold tax of 20 percent on the interest under the backup withholding provisions of the Interest and Dividend Tax Compliance Act of 1983.

Foreign branches of U.S. banks are not required to obtain Forms W-8 from their foreign customers in order to exempt interest payments to them from information reporting. However, the foreign branches are required to have other information in their records indicating that a particular customer is a foreign person in order to avoid information reporting. Mere evidence that the customer resides at a foreign address is not sufficient information on which the bank may rely for this purpose.

Obligations of international finance subsidiaries.—The third category of investments currently available to foreign investors is that of debt obligations issued indirectly in the Eurobond market by U.S. corporations through their international finance subsidiaries. These obligations generally are issued only by large corporate issuers.

The Eurobond market is essentially a network of underwriters or financial institutions that market bonds issued by private corporations, foreign governments and their agencies, and other borrowers. Purchasers of the bonds include both individuals and institutions such as banks, investment companies, insurance companies, and pension funds. Although most issues are denominated in dollars, they may be denominated in other currencies.

A well-developed secondary market exists for bonds issued in the Eurobond market; but to permit active trading in that market the bonds generally must be in bearer form and must be free from taxes withheld at the source (i.e., by the country of residence of the issuer). Because of the bonds are typically in bearer form, an investor receives interest and principal by presenting the coupons or the bonds to a designated paying agent.

The structure most frequently used by U.S. corporations to issue bonds in the Eurobond market involves the use of an international finance subsidiary incorporated in the Netherlands Antilles. The ultimate U.S. corporate borrower contributes an amount of capital to the subsidiary in the range of about one-half to one-third of the debt that the subsidiary will issue. The subsidiary then issues its bonds in bearer form in either a public underwriting or a private placement. In order to avoid registering the bonds with the U.S. Securities and Exchange Commission, the subsidiary issues the bonds pursuant to a so-called "lock-up" procedure designed to ensure that the bonds are distributed upon issuance only to foreign persons. In accordance with the lock-up procedure, the underwriters covenant not to sell the bonds to U.S. persons, and the bonds are delivered, upon issuance, to the ultimate purchasers only upon receipt of a certificate that the purchaser is not a U.S. person (or is not purchasing on behalf of a U.S. person). The bonds issued by the international finance subsidiary often are traded actively in the secondary market and are listed on foreign exchanges.

The U.S. parent (or another U.S. affiliate) of the international finance subsidiary typically guarantees the obligations of the subsidiary to its foreign investors, and the subsidiary in most cases relends the proceeds of its borrowing to the parent or other affiliate at a slightly higher rate of interest than it pays on its own bonds. (We understand that practices vary with respect to the use of the equity of the international finance subsidiary.) The Netherlands Antilles imposes a 24 to 30 percent tax on the amount that it considers to be the "spread" between these two rates and on the earnings from the "equity" of the subsidiary.

The terms of the bonds issued by the international finance subsidiary commonly provide that the foreign bondholders will receive the bonds net of U.S. or Antilles tax. Consequently, if U.S. tax were to be imposed on the interest on the bonds, the international finance subsidiary (or the parent or affiliate guarantor, if the subsidiary defaults) would be obligated to pay the amount of the tax as additional interest to the bondholder. The terms of the bonds issued by the finance subsidiary also commonly provide for optional redemption in cases in which a U.S. tax is, or is likely to be, imposed on the interest payments to the bondholders.

The U.S. tax consequences of employing the international finance subsidiary structure to gain access to the Eurodollar market are not settled. Several Internal Revenue Service audits have raised the issue of whether certain intended benefits under our income tax treaty with the Netherlands Antilles actually are available to the international finance subsidiary, and this issue has not been resolved. However, assuming that the desired tax consequences are obtained from use of the finance subsidiary structure, interest on the bonds issued by the subsidiary is free from both U.S. and Netherlands Antilles withholding taxes. Also, applying the treaty, interest paid by the parent or other affiliate to the finance subsidiary is similarly exempt from the 30 percent U.S. withholding tax. The net effect is that the ultimate U.S. borrower is able indirectly to issue bonds in the Eurobond market that bear interest that is free from all withholding tax. Assuming the structure is respected for U.S. tax purposes, the U.S. parent is able to claim a foreign tax credit for the Antilles tax.

The tax compliance provisions relating to obligations issued in the Eurobond market differ from those applicable to obligations issued directly by U.S. corporations or those applicable to bank deposits. If the interest on the obligations issued by the international finance subsidiary is paid outside the United States, no information reporting is required regardless of the identity of the recipient. Consequently, a foreign paying agent to whom a coupon is presented is not required to obtain a Form W-8 from the payee, or to obtain any other evidence that the payee is a foreign person, in order to avoid reporting the interest payment to the Internal Revenue Service on a Form 1099.

Although information reporting is not generally applicable to interest paid on finance subsidiary obligations issued in the Eurobond market, provisions were enacted under TEFRA to ensure that such obligations are held only by foreign persons. Under these provisions sanctions are generally imposed on issuers of obligations in bearer, as opposed to registered, form. However, in recognition that the foreign capital market is largely a "bearer market," Congress provided certain exceptions pursuant to which U.S. bearer obligations could be issued in the Eurobond market without subjecting the issuer to the statutory sanctions. In order for the obligations to come within the exception, the interest on them cannot be payable within the United States, the obligations must have a legend indicating that they are not to be held by U.S. persons, and they must be sold pursuant to measures designed to ensure that they are distributed upon issuance only to foreign persons.[3] Any U.S. persons who might purchase the obligations in the secondary market, regardless of the fact that they were originally targeted to foreign purchasers, are subject to certain "hold sanctions" (i.e., denial of capital gain treatment or of a loss deduction upon disposition of the obligations).

DESCRIPTION OF H.R. 3025, THE SENATE AMENDMENT TO H.R. 2163 AND H.R. 4029

H.R. 3025.—Under H.R. 3025 interest paid to foreign persons on three different categories of obligations would be exempt from the 30 percent withholding tax.[4] The first exempt category is for interest paid by a U.S. corporation, with respect to a debt obligation assumed by that corporation, which, when issued, was guaranteed by a U.S. corporation and was sold under arrangements designed to ensure that the debt would not be sold to U.S. persons. This exemption generally would allow U.S. parents or affiliates of international finance subsidiaries to assume obligations of those subsidiaries without subjecting the interest paid on the obligations to the 30 percent withholding tax.

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[3] These measures are permitted to conform with the lock-up procedures that are followed to avoid registration with the U.S. Securities and Exchange Commission.

[4] The obligations on which such interest is paid would also be exempt from the U.S. estate tax if held by a nonresident alien decedent.

The second exemption is for interest paid outside the United States on obligations (whether issued in bearer or in registered form) that, when issued, were sold under arrangements designed to ensure that the obligations were not sold to U.S. persons. This exemption would apply to interest on obligations that are sold under the same foreign-targeting procedures now employed to ensure that issuers of Eurodollar obligations are not subject to the statutory sanctions for issuing those obligations in bearer form. For instance, interest would be exempt under this provision on obligations issued in foreign markets in accordance with the typical lock-up procedures now employed in issuing obligations through international finance subsidiaries. As in the present case of obligations issued by finance subsidiaries, bearer obligations issued directly by U.S. corporations under this exemption could not be held by U.S. persons without such persons being subjected to the statutory "holder sanctions" described earlier.

The third exempt category under H.R. 3025 is that for interest paid on registered obligations in cases in which the payor (i.e., the person who otherwise would be required to withhold the 30 percent tax) has received a certificate stating that the beneficial owner is not a U.S. person. The certificate would be required to be provided on an ongoing basis with respect to each interest payment, and we expect that it would identify and provide the address of the foreign beneficial owner (as is the case with the Form 1001 that is presently used by foreign persons to claim reduced treaty rates of withholding). Because of the certification requirement, we anticipate that this third exemption would be useful primarily for those foreign persons who wish to purchase registered obligations in the domestic U.S. market but who do not have the anonymity concerns that apparently prevail in the Eurobond market.

Interest otherwise falling within one of the three categories of exempt interest under H.R. 3025 would generally not be exempt if the recipient owned at least 10 percent of the voting power of the issuer, if a corporation, or at least 10 percent of the capital or profits of the issuer, if a partnership. Interest similarly would not be exempt if it were received by a controlled corporation or if it were received by a bank pursuant to a loan agreement entered into in the ordinary course of its trade or business. In addition, the Secretary of the Treasury would be authorized to deny the exemption, with respect to newly-issued obligations, to persons resident in any country which, in the determination of the Secretary, does not exchange sufficient information with the United States to prevent the evasion of tax by U.S. persons.

Senate amendment to H.R. 2163.—The Senate-passed amendment to H.R. 2163 differs from H.R. 3025 in that it provides for a gradual phase-out of the 30 percent tax with respect to the three categories of interest covered by H.R. 3025. Specifically, under the Senate bill the rate of tax on interest received during 1984 and after the date of enactment would be five percent, and thereafter the rate would be reduced annually by one percent. As of July 1, 1988, the tax would be eliminated.

H.R. 4029.—H.R. 4029 differs from H.R. 3025, and the Senate amendment to H.R. 2163, in that it would eliminate the 30 percent withholding tax with respect to interest on obligations of international finance subsidiaries that are assumed by a U.S. parent or affiliate and obligations that are issued pursuant to measures designed to ensure that they are not sold to U.S. persons. Thus, the withholding tax would still apply to foreigners who purchase securities in regular Treasury auctions. All U.S. issuers that did not target obligations specifically to foreign capital markets would be denied the benefit of the exemption.

Although as drafted H.R. 4029 does not appear to distinguish between public and private sector borrowers, we understand from conversations with Congressman Barnard and his staff that it would be his intent to modify the bill to limit the exemption from the 30 percent tax to cover only interest on obligations of those types of issuers that have typically participated in the Eurobond market throught international finance subsidiaries. Therefore, it is our understanding that the provisions of H.R. 4029 are not intended to allow the U.S. Treasury to issue obligations in the Eurobond market free of withholding tax.

DISCUSSION

The benefits of access to foreign capital—in general.—As I stated at the outset, this Administration believes that access to foreign capital markets is benficial and that we should remove artificial barriers which prevent equal access to these markets. We believe that the more efficient capital market that will result will contribute to increased capital formation and sustained economic growth in the United States. Accordingly, we support H.R. 3025, which would improve such access through elimination of the 30 percent withholding tax on interest paid to foreign persons with respect to portfolio indebtedness.

A financial benefit would derive from any reduction in borrowing costs resulting from increased foreign demand for domestic U.S. securities. As a general proposition, lower costs of funds, particularly of longer-term funds, should stimulate investment in plant and equipment and thus lead to increased productivity and to improved international competitiveness of U.S. goods and services.

Passage of H.R. 3025 should expand somewhat the amount of savings achieved by U.S. borrowers because of increased demand for U.S. domestic securities from foreign investors currently subject to the withholding tax. The principal effect of the bill, however, would be to alter the distribution of cost savings. Under H.R. 3025, all U.S. securities, including Treasury would be affected; much of the benefit initially would accrue to holders of existing securities, but over time issuers of new securities would obtain the benefit. Among different classes of securities, Treasury does not now issue on a tax free basis. Private U.S. issuers who do not now have access to the Euromarket also would benefit from increased demand for their obligations. Because some investors might shift into domestic securities, demand for Eurobonds might decrease so that private issuers who currently borrow in the Euromarket could find their costs increased.

H.R. 4029, amended to exclude targeted issues by Treasury, would facilitate access to the Eurobond market, but only for private borrowers. Corporations now borrowing through international finance subsidiaries would retain present attractive interest costs. Some corporations which do not now borrow through finance subsidiaries would be induced to make targeted issues directly in the Eurobond market, and interest rates in the U.S. market might decline somewhat. As discussed below, however, Treasury would oppose any measure that excludes U.S. Government of agency obligations from the scope of the repeal of the tax.

Impact on capital flows and the dollar.—Elimination of the 30 percent tax would result in an increase in the gross purchases by foreigners of U.S. portfolio obligations. The extent of additional net inflow of capital would be substantially less, however, since there would be an opposite effect arising from the resulting shifts in relative yields. For example, some foreign investors would shift from U.S. corporate Eurobonds to U.S. domestic bonds. That is, the principal effect on capital flows would be a rearrangement of portfolios rather than a substantial increase in net capital inflows.

Any increased net damand for U.S. dollar denominated assets caused by repeal of the 30 percent tax would tend to increase the value of the dollar and thus have a negative effect on the competitiveness of the U.S. trade sector. However, the impact on the dollar, would occur only to the extent that investors shifted from dollar to nondollar securities and would likely not be large. U.S. and international dollar asset markets are already highly integrated because of existing exemptions to the 30 percent tax, such as the exemption for bank deposit interest. Any shift into dollar investments is likely to be small in relation to the annual foreign demand for dollars (to pay for U.S. exports of merchandise goods and services and additional U.S. assets) which now totals more than $400 billion. To the extent there is a net capital inflow, it would be a source of additional savings which would increase domestic capital accumulation.

In summary, we do not expect that repeal will have significant negative effects. We believe that the benefits of increasing efficient access to foreign capital mandate support for repeal.

Efficiency considerations.—The further integration of foreign and domestic capital markets that would results from repeal of the 30 percent withholding tax would eliminate certain existing inefficiencies and promote access to foreign capital by all U.S. borrowers.

As explained earlier, the nature of the Eurobond market is such that access on a competitive basis requires that interest be free of source-country taxation. Generally, and with the exception of banks and similar institutions, U.S. issuers now may obtain access to the Eurobond market through the use of an international finance subsidiary in the manner I described earlier. This indirect access to the Eurobond market is inefficient from the standpoint of both the issuer and the Treasury. From the standpoint of the issuer, the finance subsidiary mechanism is complex and expensive; and, as discussed, its effectiveness on a technical level is subject to question. From the Treasury's standpoint, revenue is lost due to the credit given against the U.S. tax of the U.S. parent for taxes paid by its finance subsidiary to the Netherlands Antilles.

Financial markets would be more integrated and efficient if the segmentation between the U.S. domestic capital markets and the Eurobond market, attributable to the 30 percent withholding, were eliminated. Enactment of legislation to repeal the 30 percent tax on interest paid to foreign persons would allow U.S. issuers to issue their obligations directly in the Eurobond market, avoiding the inefficiencies of routing such obligations through an international finance subsidiary, and would remove an impediment to foreigners investing in obligations issued directly. While there would still be differences between the domestic bond and Eurobond markets due to differences in regulatory regimes and the prohibition against new issues of bearer securities with maturities over one year in the United States, removal of the withholding tax would greatly facilitate the integration of the two markets.

Nondiscrimination.—Access to foreign markets should be ensured on a nondiscriminatory, as well as an efficient, basis. Consequently, we believe that the distinction made under current law between banks and similar financial institutions, which can borrow foreign capital directly, and other issuers, which must borrow such funds indirectly through financial intermediaries or offshore finance subsidiaries, is unjustified. Consistent with our position that corporate issuers as well as financial institutions should have direct access to foreign capital markets, we believe that direct access also should extend to the U.S. Government and its agencies.

The Treasury Department is effectively precluded from tapping the Eurodollar bond market directly because of the foreign withholding tax. The Tax Equity and Fiscal Responsibility Act of 1982 allows the Treasury to issue bearer securities abroad as long as procedures are in place to make reasonably sure that U.S. residents do not buy them; but a withholding tax on these issues, which can differ for residents of different countries because of tax treaties, acts as an effective bar for a true Eurobond issue. Further, residents of foreign countries are to some extent inhibited from buying long-term Treasury securities in the U.S. because of the withholding tax. Consequently, the current situation is that U.S. corporations can issue bonds to the foreign segment of the worldwide market for dollar-denominated securities with a tax advantage over Treasury securities. We find this situation unjustified.

We understand that some people argue that U.S. Treasury securities should not be included in a removal of the foreign withholding tax. It is true that if Treasury securities were exempt from the foreign withholding tax, as they would be under H.R. 3025, then some foreigners would undoubtedly shift from Eurobond corporate securities into Treasuries. This shifting could cause some increase in interest costs from what they otherwise would be for those large corporate issuers which currently have access to the Eurobond market, but we cannot accept the argument that Treasury (and thus the general taxpayer) should pay more so that some U.S. corporations may pay less. Allowing foreigners greater access to U.S. Treasury securities by removing the barrier of the withholding tax should reduce Treasury's debt servicing costs from what they otherwise would be. Treasury's (and the American taxpayer's) claim on this potential benefit should not be subordinate to any other sector's claim, and legislation repealing the withholding tax should include Treasury securities.

In this circumstance, we strongly favor H.R. 3025. We oppose any proposal that would treat Treasury or other governmental agency obligations differently from corporate issuers in the scope of the repeal of the 30 percent withholding tax.

Compliance.—The provisions of H.R. 3025 and H.R. 4029 are carefully structured to provide access to the Eurobond market in a simple, straight-forward manner while guarding against the possible use of these provisions by U.S. persons to evade U.S. taxes. In this regard, it must be recognized that the possibility currently exists that U.S. persons may hold interest-bearing obligations outside the United States and may effectively evade U.S. tax. We would note, however, that neither H.R. 3025 nor H.R. 4029 would decrease the protections against abuse or evasion that currently apply with respect to obligations issued through international finance subsidiaries. In either case, the requirements of current law that I have described require that certain procedures be followed to ensure that bearer obligations be targeted to foreign markets and apply sanctions to U.S. persons who hold such obligations. These procedures are well designed to provide the maximum protection against possible evasion while not interrupting the normal flow of economic transactions.

We will, of course, continue our surveillance of the general compliance issues associated with participation of U.S. persons in international financial markets and we will be pleased to consider suggestions that the committee may have in this regard.

Revenue impact.—The projected revenue impact of H.R. 3025 and H.R. 4029, respectively, is summarized in Table 1, which is appended to my written statement. As indicated on Table 1, the Treasury Department now estimates that the enactment of H.R. 3025 almost will be revenue neutral during fiscal years 1984 through

1987. If the foreign tax credit anti-abuse provisions of H.R. 4170 are assumed to be in force, there will be a revenue gain of about $23 million; in the absence of these provisions, there will be a revenue loss of about $16 million. If all of these provisions are considered as part of a single, integrated reform, which is the Treasury Department's view, there would be a three-year net revenue gain to the Treasury of about $415 million. These estimates do not take account of any collateral effects, such as lower interest costs to the U.S. Government, which may result from the legislation.

Because the revenue estimates are based on a complex series of assumptions, it may be useful to outline the steps involved in making the estimate and to describe the kinds of assumptions to have to be made. One component is the projected amount of revenue that would be withheld in the absence of repeal. This is based on data on actual collections in 1982 combined with projections of the growth in interest payments after 1982. Estimates of the amount of obligations held by persons not within the scope of the proposed repeal, including foreign banks and related persons, are also based on a sample from actual collections in 1982.

The most difficult part of the estimating process is determining what percentage of the outstanding Eurobond issues would be assumed by the U.S. parents of international finance subsidiaries. This is important because of the saving to the Treasury of U.S. taxes against which credits for foreign tax would otherwise be taken. A related question is whether any new issues would continue to be made through international finance subsidiaries. In either case, the Treasury has attempted to evaluate all the information available on the issue and has made conservative assumptions on the amount of foreign tax credits saved. Since almost all financings are made through the Netherlands Antilles, we use a Netherlands Antilles finance subsidiary as the model case.

I would like to emphasize that the Treasury's support of repeal of the 30 percent withholding tax on interest has never depended on whether there was a revenue gain or loss, but on the desire to end a discriminatory and inefficient system and to further intergration of world capital markets.

CONCLUSION

The Treasury Department strongly supports H.R. 3025. We urge the Committee to work for its inclusion in the conference on H.R. 4170 and H.R. 2163.

TABLE 1.—SUMMARY OF FISCAL YEARS 1984–87 REVENUE EFFECT OF VARIOUS PROPOSALS TO REPEAL 30 PERCENT WITHHOLDING

[In millions of dollars]

	With H.R. 4170 [1]	Without H.R. 4170
Gibbons-Conable (H.R. 3025)	+23	−16
Barnard proposal	+166	+127
Senate bill	+211	+28

[1] The revenue estimates in this column are based on the asumption that the foreign tax credit antiabuse provisions of H.R. 4170 were in effect but they do not include revenue gain attributable to the antiabuse provisions.

The revenue gain from the foreign tax credit antiabuse provisions of H.R. 4170 is $392,000,000 for fiscal years 1984–87. Thus, the combined revenue gain of H.R. 3025 and these provisions is $415,000,000 for the period.

TABLE 2.—REVENUE EFFECT OF VARIOUS PROPOSALS TO REPEAL 30 PERCENT WITHHOLDING IF THE FOREIGN TAX CREDIT ANTIABUSE PROVISIONS OF H.R. 4170 ALSO ARE ENACTED

[In millions of dollars]

	1984	1985	1986	1987	1988	1989	1984–87	1984–89
Gibbons-Conable (H.R. 3025)	0	−2	3	22	36	42	23	101
Barnard proposal	10	34	50	72	90	101	166	357
Senate bill	21	57	63	70	65	54	211	330

STATEMENT OF HON. THOMAS J. HEALEY, ASSISTANT SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. HEALEY. I am pleased to have this opportunity to advise you of the Treasury debt management implications of removal of the 30 percent withholding tax on investment income paid to foreigners by U.S. entities.

H.R. 3025, the Conable-Gibbons bill, by repealing the foreign withholding tax and removing an impediment to foreign investment in Treasury securities, accomplishes three things: One, it noticeably improves the market for treasuries; second, it reduces the interest paid on the public debt; and third, it lowers costs to the American taxpayer.

Thus, H.R. 3025 would be consonant with the current efforts, of which this committee is painfully aware, of the Congress and the administration to reduce Federal spending. The $1.49 trillion of public debt which we currently have outstanding is growing rapidly, and the interest on this debt is presently about $150 billion a year. Given the volume of our new issues, any savings we can achieve in interest costs will be welcome.

At present, the Treasury Department is effectively precluded from tapping the Eurobond bond market directly because of the foreign withholding tax. TEFRA allows the Treasury to issue bearer securities abroad as long as procedures are in place to make reasonably sure that U.S. residents do not buy them, but the withholding tax on these issues acts as an effective bar for a true Eurobond issue.

Further, residents of foreign countries are inhibited from buying long-term Treasury securities directly in the United States because of the withholding tax.

Yet, very few foreign investors actually pay the full 30 percent withholding tax. For residents of certain countries with which we have tax treaties, this tax is reduced, in some cases to zero.

Also some foreigners may attempt to evade the tax by strategems, such as selling their portfolio of U.S. Treasury securities to a security dealer the day before an interest coupon payment is made and buying it back the day after. In these transactions, the hoped-for tax result is that there will be no withholding, since it is argued that the foreigner did not own the securities on the actual coupon payment date.

On the other hand, the dealer who purchased the securities for 2 days and then resold them has foreign income from the securities pro-rated only for the day or two he actually held the securities. The net result is a tremendous loss to the Treasury.

Under these circumstances, less than $175 million annually is collected from the foreign withholding tax, while the existence of this tax has caused tax enforcement and policy problems and has encouraged the use of financial shells to sell bonds free of the withholding tax.

We are currently seeing new types of avoidance arrangements proposed in the market, one example being long-term Eurobond CD's issued by savings and loans, which would be proposed to be fully secured by Treasury securities. CD's are generally exempt from the foreign withholding provisions and presumably such a security might be also.

This kind of evasion is not a healthy state of affairs. The financial markets would be more integrated and much more efficient if the artificial segmentation between the U.S. capital markets and the Eurobond market were removed.

The principal reason for the large interest rate spreads between the Eurobond and the domestic bond market, a spread which currently may be as high as 90 basis points, is the imperfection caused by the foreign withholding tax. There would still be slight differences between the two markets after removal of the withholding tax, but this removal would greatly facilitate arbitrage between the two markets.

It would also remove a tax advantage available only to corporations with access to the Eurobond market through the Netherlands Antilles subsidiary, an advantage that other issuers of securities, including the Treasury, do not have.

Now, I understand that some people argue that Treasury securities should not be included in the removal of the foreign withholding tax. But the U.S. Treasury cannot accept the implicit argument that Treasury, and thus the taxpayer, should pay more so that some large corporations may pay less.

Allowing foreigners greater access to Treasury securities by removing the withholding tax should reduce Treasury's debt service costs from what they otherwise would be. The U.S. taxpayer's claim on this potential benefit must not be subordinate to any other sector's claim, and the legislation repealing the withholding tax must include Treasury securities.

In conclusion, Mr. Chairman, we strongly support the approach of H.R. 3025 to the foreign withholding tax issue. We believe it is appropriate that this tax should be repealed, not just on Eurobond issues, but on domestic issues as specified in H.R. 3025, as well.

This approach benefits Treasury debt management by removing an unnecessary barrier to foreign investment on U.S. Treasury securities. To permit the efficient management of the public debt, the foreign withholding tax should be eliminated.

I thank you, and we would be pleased to answer questions.

Chairman ROSTENKOWSKI. Thank you very much.

Mr. Healey, there is a great deal of concern with the present strength of the U.S. dollar in international trade. I would like you to share with us your observations on the potential change, if any, in capital flows and the value of the dollar.

What do you foresee happening if the 30 percent withholding tax is repealed? Would that not have a tendency to strengthen our dollar even more?

Mr. HEALEY. We have looked at that question, Mr. Chairman, and clearly there will be some impact, but the analysis that we have done makes it very difficult to believe that there would be any significant effect, and I think the evidence of that is the small amount of present withholding, under $200 million a year, when you compare that to the very large size of the balance-of-payments deficits, the implication of that is that the impact should be very modest, if any.

Chairman **Rostenkowski**. I do not know whether you would consider it a modest impact. I could see it not having a long-range impact. I could see a short range implication. However, I do not know how you can judge whether or not the strength of the dollar will be lessened.

Mr. **Pearlman**. One of the questions, Mr. Chairman, is the extent to which there will be net inflows into the United States, as distinguished from a rechanneling of capital already invested in the United States. I think that is what makes the estimate difficult.

I do not think there is any question from the analysis that we have done that there is bound to be some additional attractiveness to U.S. dollar-denominated issues emanating in the United States as a result of repeal. Whether that means there will be net flows into dollar-denominated assets is the real question.

Foreigners today invest very heavily in U.S. dollar-denominated assets abroad, and it may simply be a shift from those dollar-denominated assets into ones issued out of the United States, and that is the place where we found it difficult ourselves to reach any conclusion that there is going to be any major upward pressure on the dollar.

And indeed, in our discussions with people outside of Treasury we have not found any greater guidance on that point.

Chairman **Rostenkowski**. You have been quite emphatic regarding the Department's position for straight repeal. There is no question that this will have an adverse effect on the Netherlands Antilles.

Do you favor any assistance to the Netherlands Antilles if Congress repeals the 30 percent withholding tax?

Mr. **Pearlman**. Well, yes. Let me say that our feelings about repeal have been long known and are really unrelated to the Netherlands Antilles or to the international finance subsidiaries. Hopefully, we made that clear this morning.

Clearly, we accept the Netherlands Antilles' statement that has been made to us and has been made publicly that this is going to have an effect on the Antilles. That motivated the Senate Finance Committee to adopt the phaseout——

Chairman **Rostenkowski**. But you are opposing a phaseout.

Mr. **Pearlman** [continuing]. Of the provision. We are sensitive to the problem of the Antilles. We would hope that through the continued treaty negotiations and through the other efforts that hopefully this Government would make in dealing with the Antilles, that the effect will be softened.

I would have to say, Mr. Chairman, that we do believe that there is an overriding issue here, and that is freeing up these capital markets. And for that reason, we do put a priority on the full repeal, recognizing that it will have an effect on the Netherlands Antilles.

Chairman **Rostenkowski**. Mr. Conable is recognized.

Mr. **Conable**. Mr. Chairman, I would like an opening statement that I inadvertently failed to give because I was not here at the beginning of the hearing be put in the record immediately following your statement.

Chairman **Rostenkowski**. Without objection, it will be inserted in its entirety following the Chairman's opening remarks.

Mr. **Conable**. I would like to thank the Treasury for its support of this proposal, which has been pending for a long time. I realize that timing is everything, and it appears to be your view that the timing is appropriate now to repeal this.

Is not the issue of overriding importance access to the Eurobond market under circumstances which give a fairly level playing field. We do not have that now, do we?

Mr. **Pearlman**. Absolutely, Mr. Conable. I think that is the fundamental issue here, that we clearly do not have that now. Not only do the U.S. Treasury and other Government agencies not have access to the capital markets now, but certain smaller corporations in the United States do not have full access to those capital markets.

From our standpoint, the level playing field is what we should all be interested in, and Mr. Gibbons' and your bill will achieve that.

Mr. **Conable**. Let me say also, I quite agree with your statement that the impact on the dollar is marginal compared to many other issues that are much more central to the level of interest rates and the pressure on the dollar that we are all aware of from fiscal excess of one sort or another.

And I hope this strong support from Treasury will have that effect. I personally believe also that phasing out over a 5-year period is somewhat chaotic. Were we to let withholding stand in the law the chances are we would be back here long before the 5 years were up, moving to repeal the vestiges of the withholding tax, because of the need to take more dramatic action before that time.

Mr. Chairman, I have no questions.

Chairman **Rostenkowski**. I thank the gentleman.

Mr. Guarini will inquire.

Mr. **Guarini**. How do we treat real estate, as opposed to interest? We recently changed our rules. Where we had no capital gains tax on real estate if it were held by a foreigner that did not live in the United States more than 6 months and 1 day, now we have changed our regulations that capital gains on real estate is payable by a foreigner as it is an American citizen.

Now, the present real estate treatment by the recent regulations, does that allow for any withholding whatsoever?

Mr. **Pearlman**. On real estate?

Mr. **Guarini**. That is right.

Mr. **Pearlman**. The Gibbons-Conable bill—neither of these bills deal with real estate.

Mr. **Guarini**. I know that, but I am inquiring about consistency of philosophy as a matter of good tax policy. What you are doing on interest is to put interest in the same category that real estate was in 3 years ago, and in the recent bill in TEFRA we put real estate in the same category that interest was previously.

In other words, where is the consistency in tax policy?

Mr. **Pearlman**. TEFRA did not impose withholding on real estate gains on foreign investors.

Mr. **Guarini**. Well, the proposed regulations were that you had to put up a performance bond if you bought a piece of real estate.

Mr. **Pearlman**. That is correct, and there is a provision in the Senate bill that would require, if it were enacted, withholding on gains involved in the sale of real estate.

Mr. **Guarini**. Right, so if you bought a piece of real estate there would be withholding, as I understand, 10 percent; is that right? Was that the regulation that was proposed within the last month or so?

What I am asking is, Why do we withhold—or treat real estate different than interest? We treat a foreigner like an American in regard to real estate, but now we do not want to treat a foreigner like an American in regard to interest.

Where is the consistency?

Mr. **Pearlman**. I think there is a consistency. Let me see if I can articulate it. The notion with respect to interest is that there should be no source country taxation. That is, that the obligation is properly taxed in the country of residence.

Indeed, that concept is present even domestically within the United States. If I own an obligation issued by a New York corporation, it is taxed in my State; it is not taxed in the State of New York if I do not live there.

Mr. **Guarini**. We are talking about Federal taxes and the difference between personalty and realty for foreigners and American citizens should be consistent. I am just wondering why the Treasury Department comes up with a totally different philosophy in regard to these two different kinds of business holdings.

Mr. **Pearlman**. Again, Mr. Guarini, I suggest they are not inconsistent, because the nature of the income is different. Traditionally, income on intangible assets such as debt, interest income, is in the international environment deemed to be appropriately taxed by the country in which the recipient resides, and that is the reason under our tax treaties that we will typically reduce our withholding, for example, give the other country the opportunity to tax that gain.

With real estate, the concept is that property is physically present, located in the United States, and there is income being generated in the United States from that real estate, and as a result it is appropriate to have taxation in the United States.

So I would suggest to you that it is not inconsistent to make a determination that interest earned on U.S. debt by foreign persons who have no connection with the United States not be taxed in the United States, whereas profits in connection with the ownership of real estate is taxed in the United States.

I do not think under traditional international concepts that those principles are——

Mr. **Guarini**. International comity is one thing, but the sovereignty of a country should determine when money is earned within that country how that money is to be treated. So therefore we have interest which is earned either by bank accounts, or it could be interest from rents from real estate itself, and then if a person sells real estate he now has to have a withholding tax.

But if he earns foreign income from rents and profits on real estate, he does not have to have a withholding tax. That to me is totally inconsistent. I am just wondering what special interests are being favored in a bill like this. Where does this bill generate from? Are there any particular international banking interests that have a special interest in seeing that a bill like this gets passed?

Is there interest by huge international bankers that are interested in tapping into the American market so that there could be what is the equivalent of a tax-free status? I do not ask you to answer that question, but just think about it.

And the other question is, If the American Government does borrow in a foreign market, is that not only going to strengthen the dollar but push up the interest rates internationally, because you are crowding the marketplace because there will be more people that are bidding for the same amount of Eurodollars in the foreign markets?

So what we are really doing is going contrary to good world economic policy. We are strengthening the dollar, which is the bane of our existence with respect to our large trade deficit. At the same time, we are raising international interest rates, and it seems inconsistent for a national policy.

Mr. HEALEY. Let me answer the rate question, and I think probably the easiest way to do it is to look at what the rates were—the most recent I have were April 26—for similar kinds and qualities of securities in the domestic and Eurobond markets. Basically, for a 7-year maturity instrument the Eurobond market was 79 basis points lower, and for a 10-year instrument it was 90 basis points lower.

The point of that is that we have an anomaly in the market. We have an imperfection in the market, caused by the U.S. withholding tax, that has the Eurobond market lower in cost than the rest of the international financial market.

It is not that we would push rates up; it is that we would try to get all of those markets into equilibrium. That is what we are desiring to do. At the moment you have a market that has a privileged position, a protected position, because of the withholding, and all we are trying to do is to get rid of that protected position so that that market is internationalized and participates with the rest of the world, any more than what we are trying to do in arguing with Japan that they open their markets up to the United States and all foreign issuers.

Chairman ROSTENKOWSKI. Mr. Moore will inquire.

Mr. MOORE. No questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Gibbons will inquire.

Mr. GIBBONS. Mr. Chairman, I hope Mr. Guarini will pay attention to what I am about to say. This is my bill, Frank. This is not Treasury's bill.

Mr. GUARINI. I understand that, Mr. Gibbons.

Mr. GIBBONS. And a number of other Members are interested with me. First of all, this bill raises money for the U.S. Treasury.

Second, it lowers U.S. interest rates, and it takes out a complete tax anomaly in the law. If Americans want to borrow money now or want to—if a foreigner wants to buy a U.S. obligation now, he will not buy it unless it is issued in the Netherlands Antilles. That allows large American corporations to go to the Netherlands Antilles, set up a subsidiary, issue debt obligations that are tax free of American tax.

The foreigner has to pay tax to his own country on the interest he earns. So the large corporations already have a tax free way of raising money through that market. This bill would allow the small issuers of obligations to borrow in the same market. It will make borrowing for this kind of long-term obligation compatible with all other laws that we already have on the books.

Am I not correct?

Mr. PEARLMAN. Yes; that is correct.

Mr. GIBBONS. What we are doing now is discriminating against small American businesses borrowing long term in a foreign market. Every other kind of American debt obligation can borrow in foreign markets without this kind of discrimination.

This, in effect, is a tariff on importing capital for small businesses. That is what it is, and that is what I am attempting to get rid of and that is all I am attempting to get rid of.

Mr. GUARINI. Would the gentleman yield?

Mr. GIBBONS. Certainly.

Mr. GUARINI. If the problem is the tax treaty, then attack the problem. To make everybody else be tax free or to have no tax is going in the wrong direction.

Mr. GIBBONS. All that would mean is that American businesses, both large and small, could not borrow American dollars in the international market. That would mean that every other form of American debt obligation could borrow in the foreign market without any tax obligation——

Mr. GUARINI. If the gentleman would yield again.

Mr. GIBBONS [continuing]. For the foreign owner of the debt. You know, if you want to put a tax on all foreign debt overseas, you would effectively cut off enough capital flow into the United States to probably raise the interest rate a number of percentage points. It would probably be really Paul Volcker's real, real tight money market then, because we are importing a lot of capital into the United States.

The testimony in our Trade Subcommittee for the last 2 weeks has been that without the foreign borrowing that we are able to do now that interest rates in the United States would be far higher than they are. Now, Treasury and some of us others are trying to lower interest rates.

We are trying to put all borrowers on the same parity, whether they are large borrowers or small borrowers, whether they are long-term borrowers or short-term borrowers. That is all we are trying to do. There is no great big mystery about this bill. In fact, it is not very complicated.

Mr. GUARINI. If the gentleman would yield, I would like to suggest that a short-term gain that we are aiming for in this bill may in the long run be a great loss. And what I am really concerned about, furthermore, is the dependency upon foreign money, because we have more and more foreigners owning a larger and larger piece of our economy.

Mr. GIBBONS. Well, that is not really a result of the tax law.

Mr. GUARINI. And the more that that is continued, the more we will be dependent upon them in the event that they wish to pull out the money.

Mr. GIBBONS. Frank, that is not really a result of the tax law. That is the result of the fact that there are an awful lot of U.S. dollars overseas, hundreds of billions of dollars' worth of them over there. Now, we can either use them or we can let every other foreign borrower use them.

If we use them it saves us money in the long run, because we become more competitive and we have use of our capital.

Mr. GUARINI. But, Mr. Chairman, Mr. Gibbons, this bill encourages foreign investors. It gives them a wide-open door to borrowing more money from our Treasury bills and our banks, which actually makes us more dependent upon their control position.

Mr. GIBBONS. Frank, you can already do that if you are a foreigner. You can buy a certificate of deposit and there is no tax on them. You can buy all kinds of things that there is no tax on, U.S. obligations.

Mr. GUARINI. Why give them an extra incentive? Because this is going to give them that much more interest to come in.

Mr. GIBBONS. Frank, all you are doing in your zealousness is discriminating against one class of borrowers. They are principally small borrowers who are trying to borrow long term to get the capital that American business needs to operate and be competitive in a world environment, that is all.

If you want to discriminate against small businesses trying to be competitive in a world environment, then you should vote against this bill.

Mr. GUARINI. I would like to suggest that what this bill really does also, Mr. Gibbons, is that it gives incentives for the sophisticated big borrowers who understand international tax matters, and the small borrowers are not that sophisticated.

Mr. GIBBONS. They go down to that Netherlands Antilles that you are familiar with and they borrow through that market and the owner of the obligation pays no U.S. tax. So big businesses in America already have the advantage of that and they will continue to have the advantage.

Chairman ROSTENKOWSKI. The time of the gentleman has expired.

Mr. Pease will inquire.

Mr. PEASE. No questions.

Chairman ROSTENKOWSKI. Mr. Dorgan will inquire.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Pearlman, as a former tax administrator I am real curious about the compliance problems you are going to face with the broad approach that you describe. Mr. Guarini's questions I think are relevant, and the question is, if you have the approach you describe with bearer bonds in the Eurobond market proliferating, how on Earth are you going to solve the compliance problems that that is going to create?

Mr. PEARLMAN. Mr. Dorgan, there would be possibly a larger volume of obligations out there, but the compliance problems are no different than they are today.

Mr. DORGAN. You mean the compliance problems in the situation where you have no withholding is no different than the situation where you have withholding?

Mr. PEARLMAN. No; we have that problem today. Every Eurodollar transaction is a no-withholding transaction, and the compliance problem you mention is the one of a U.S. investor, U.S. person, going overseas and investing in an interest-bearing obligation and not reporting that income in the United States, bringing it back or depositing it overseas.

That problem is present today. Indeed, it is present even if you go beyond the Eurodollar market. If I want to go to Switzerland and open up a Swiss bank account and buy a United States dollar-denominated obligation of a German bank, for example, and not report it to the United States, that presents a compliance problem to us.

If the obligation is issued in the United States, then we think that the TEFRA provisions that were enacted to try to deal with bearer obligations do give us the compliance tools that we need to reasonably assure that those obligations will not be purchased by U.S. persons or, if they are, that they are properly reported.

Obviously there is going to be some noncompliance. There is noncompliance today. But we do not view the compliance issue to be a more serious one simply because of an extension of the repeal—of the repeal of withholding. And the key item to remember there is that we have plenty of opportunities for U.S. persons to invest abroad today and not report interest income. That is very present in our law today.

Mr. DORGAN. Let me just repeat what you have said. You are saying that, as a tax professional, you do not perceive the compliance problems to increase as a result of the repeal of withholding? Is that what you mean to say?

Mr. PEARLMAN. I am saying that we do not think that we have any different compliance problem under the full repeal of withholding than we have today. We clearly have a compliance problem any time you put a taxpayer in the position where he can purchase an obligation and avoid reporting that interest income.

We have that problem today, and hopefully we will see over the next several years that the TEFRA provisions that Congress enacted will permit us to deal with that problem.

Mr. DORGAN. Maybe you are answering a question that I have not asked. I am trying to ask a question about the quantity of compliance problems. Clearly, the magnitude—if you are talking about a problem and saying that problem will not change, the magnitude of the problem will change dramatically, will it not?

If this broader approach accomplishes what you expect it to accomplish, will not the magnitude of the compliance problem increase dramatically?

Mr. PEARLMAN. Well, not necessarily. I would respond to you, no, and the reason is the incentive we are trying to obtain is not additional investments by U.S. persons; it is additional investments by foreign persons.

Mr. DORGAN. I understand that.

Mr. PEARLMAN. Without regard to repeal of withholding, today a U.S. person may choose to evade U.S. tax by going abroad and investing in a foreign obligation today and not reporting that income. A taxpayer has the opportunity of doing that today. The problem is not going to be any different if withholding is repealed.

We have that problem today and it is one that we have to deal with. It is one that Congress chose to deal with in 1982, and that is why I would suggest to you that the problem will not increase.

I do not mean to make light of the compliance issues. We are obviously very interested in making sure that U.S. taxpayers fully report interest income, no matter where they invest and no matter where they hold a security. But we do not think that issue is one that is magnified by the proposed withholding.

Mr. DORGAN. The reason I ask the question is I am interested in asking other persons who testify today on their view of that compliance problem. I understand that you attempt to paint it as a very minimum kind of problem. I happen to think it is a very major problem. It opens up a whole new vista of opportunity for tax avoidance.

Let me ask one final question. The broad approach that you espouse, as opposed to some of the alternatives that will be discussed today, would allow foreign investors the opportunity to purchase U.S. domestic securities free of U.S. withholding taxes. Would the U.S. citizen find a comparable opportunity in the purchase of foreign securities free of foreign withholding taxes with respect to most countries?

I am asking whether you are suggesting an exemption for a foreign investor in a U.S. security that a U.S. investor in a foreign security will not have.

Mr. PEARLMAN. Mr. Dorgan, I am advised that it varies depending on our treaty arrangements. There are countries, for example the United Kingdom and I think Germany, in which there is full relief from withholding, and indeed, as Mr. Healey mentioned, our discussions with Japan are along the same lines.

Mr. DORGAN. But with those exceptions acknowledged, in most instances a U.S. investor in a foreign security in most instances around the world will discover that a foreign withholding tax is imposed, is that not correct?

Mr. PEARLMAN. Yes, I think that is correct.

Mr. DORGAN. And therefore, you are suggesting that the foreign investor in a U.S. security receiving income from this country shall be free of withholding requirements that a U.S. investor of a foreign security will still face from a foreign country in most instances.

Mr. PEARLMAN. Yes; to the extent that we do not have a treaty arrangement, that is correct.

Chairman ROSTENKOWSKI. Mr. Thomas will inquire.

Mr. THOMAS. Thank you, Mr. Chairman.

Continuing along those lines briefly, you indicated what H.R. 3025 would do would be to create some consistency within U.S. law, a level playing field. And Mr. Dorgan's question was, carrying it to the international scene, what kind of a level playing field would there be between U.S. investors in other countries and foreign investors in the United States, and you indicated it would depend upon the treaties around the world.

If we are talking principally about the Eurodollar market, you indicated Great Britain and West Germany would be withholding-free. What about France or any other major European nations?

Mr. **Pearlman**. Under the new treaty with France, Mr. Thomas, there would be no withholding. A U.S. investor would not be subject to tax.

Mr. **Thomas**. What about the Netherlands?

Mr. **Pearlman**. None on the Netherlands.

Mr. **Thomas**. Denmark?

Mr. **Pearlman**. No.

Mr. **Thomas**. In the instance of the U.S. investor in the European bond market, the relationship would be essentially the same if H.R. 3025 is enacted?

Mr. **Pearlman**. I think that is correct.

Mr. **Thomas**. If you are arguing strongly for H.R. 3025 and want U.S. Treasury participation in the Eurobond market without any restrictions which some others are going to advocate that should be done, give me some kind of feeling in terms of the aggressiveness of the U.S. in pursuing the European market.

One of the comments is that the U.S. Government forces folks out of the market in the United States. Is this going to then be a worldwide problem, and what is the extent in terms of money available, and what would the United States soak up vis-a-vis private availability?

Mr. **Healey**. The reason why we are supporting this so strongly is not that we are trying to change anything in the markets other than to remove an artificiality in one small segment of the international market, which is the Eurodollar market. By allowing Eurodollar purchasers to purchase free of withholding, they can choose whatever security they wish to purchase, whether it be Treasuries or corporate securities of U.S. corporations or whether it be European countries or other countries——

Mr. **Thomas**. My question is what will be the impact in the U.S. markets—I assume one of the reasons they want to hold these securities is because of the stable nature of the U.S. system, and if they cannot get Treasury notes then the corporate notes are fine.

But if they can get Treasury notes then that is even better, and I want to know if you have analyzed what the impact would be. I know the dollar amount you have indicated already you do not know for sure. What about crowding out?

Mr. **Healey**. What we perceive happening is the following. We currently issue, unfortunately, approximately $1.5 trillion of securities. We would perceive that by broadening the market there would be a modest, a very modest likely decrease in the cost that the Treasury pays on our interest bill.

But every other security and every other borrower, be it a AAA corporation or a small farmer or a small consumer, all of those other financing costs are pegged off treasuries and to the extent that Treasury costs are lower all other costs will be slightly lower to the same extent. And that is what we mean when we say that by opening the market up a little bit to equality everybody is going to benefit, not just the corporations that currently can use the Eurodollar market.

Mr. **Thomas**. There is not a limited amount of dollars available, and the U.S. entry would not preclude those dollars going somewhere other than the Treasury?

Mr. **Healey**. Well, indeed, from the point of view of any borrower in the United States this would increase the amount of dollars available. It would increase the supply of loanable funds, and that is what would cause the price for those funds, the interest rates, to decline.

Mr. **Thomas**. You do not think there would be corporations participating in the Eurobond market that would be forced to come back to the domestic financing areas because of the U.S. participation?

Mr. **Healey**. I think there well could be, but you asked the question about available funds and there clearly will be available funds, and indeed more available funds, for those corporations.

Mr. **Thomas**. Let us talk for a minute about Netherlands Antilles. I read where some folks have said that the Eurobond market is about 30 percent of their gross national product, something like that. Obviously we are going to have a significant impact.

Is there any indication of treaty renegotiations with the Netherlands Antilles?

Mr. **Pearlman**. Mr. Thomas, we are in the process of negotiating a treaty with the Netherlands Antilles now. Those negotiations from our perspective have proceeded and will continue to proceed separate and apart from the pending legislation, and we would hope to consummate a treaty ultimately.

Mr. **Thomas**. Do you have a timetable on that, Mr. Pearlman?

Mr. **Pearlman**. Well, we have suggested timetables so often, Mr. Thomas, I am reluctant to indicate one. We had hoped to have a treaty completed by the end of January, and principally because of the press of tax legislation in the Congress that was impossible.

It is a complicated treaty and we have, I think, found good faith negotiations on both parties' parts, and we are just working toward on——

Mr. **Thomas**. One last question. Where are we in terms of transition? If we had the Netherlands Antilles in a treaty and U.S. corporations creating subsidiaries there for purposes of getting into the Eurobond market, we have ongoing obligation.

What is the transition procedure? How are we going to work ourselves out of where we are and where we are going to be if H.R. 3025 comes along?

Mr. **Pearlman**. Well, I am going to treat that as two questions. Leaving the Internal Revenue Service audits aside for the moment, I would hope, we would hope, that under the legislation—that presently outstanding obligations would not be adversely affected by the legislation. And when I say "adversely affected" I mean by other aspects of the legislation that is contained in both H.R. 4170 and in the Senate bill, other than the withholding repeal.

And I think we are along the way to making sure that the grandfather provisions in the bill will assure the present issuers that their current obligations are not going to be adversely affected by the legislation.

As I am sure you are aware, we would normally not comment on audit activities being conducted by the Internal Revenue Service.

Several of the corporations who have been the subject of examinations involving Eurodollar transactions have themselves made those examinations public, so it is public knowledge.

Those examinations will proceed. The facts vary, the facts will vary from case to case, and ultimately the Revenue Service and taxpayers will have to resolve those issues. Again, we do not tie a resolution of those issues to this legislation.

Chairman **Rostenkowski**. Mr. Jenkins will inquire.

Mr. **Jenkins**. Thank you, Mr. Chairman.

Mr. Secretary, I want to pursue this just a moment. Mr. Gibbons' statement that this is primarily, of course, to help the small businesses because they can do indirectly through the Antilles that which they ought to be able to do directly, I have no problems with that. I agree with that.

But this bill goes much beyond that. I understand the approach, you are proposing that for the first time we are going to permit the financing in the foreign marketplace of U.S. obligations on a tax-free basis. As far as this country is concerned, we will be repealing entirely the withholding as far as the interest on foreign purchases of U.S. obligations, is that correct?

Mr. **Healey**. Yes; that is correct.

Mr. **Pearlman**. Let me just add something, Mr. Jenkins, because I think it is important that the extent to which the law is being changed by the Gibbons-Conable bill be understood. Under current law, not only are Eurodollar transactions that are routed through the Netherlands Antilles exempt from tax, but bank deposits in the United States owned by foreigners are exempt from tax, and that is an extensive amount of investment in the United States that is not currently subject to tax.

So our analysis—on the other hand, the bills do not exempt from tax, neither Congressman Barnard's bill nor Gibbons-Conable exempt from tax, a loan transaction between related parties or loans by foreign banks in the ordinary course of their business.

Our analysis would indicate that somewhere between 50 and 75 percent of the tax that is currently collected under the withholding provision, approximately $180 million of taxes that we collect a year, is attributable to obligations that would not be exempt from tax by this pending legislation.

Mr. **Jenkins**. Let me pursue this just a moment. I understand that you would be saving some in financing the Federal debt by being able to go directly to the foreign marketplace on a tax-free basis, in effect, because of the absence of withholding.

Now, I am assuming that you would transfer today some of the taxpaying portion of the national debt, because people are collecting interest and paying taxes on that. You would lose that into the foreign marketplace, is that correct?

Mr. **Healey**. Presumably, yes.

Mr. **Jenkins**. Well, your figures as to revenue gain or loss, does that take that into consideration?

Mr. **Healey**. It does in the sense that a current owner of Treasury securities in the domestic market, because the price for Treasury securities rises because of the increased demand—that is what causes the overall interest cost to go down—will sell his Treasury securities or her Treasury securities, but buy some alternate security in the U.S. domestic market, which if he gets a higher interest rate for it will cause him to pay even more interest—more income tax because he is earning a higher interest on the other security.

Mr. **Jenkins**. So you are saying that is a wash, in effect?

Mr. **Healey**. Yes; that that will settle out. Indeed, it could be higher.

Mr. **Jenkins**. Assume from your statements that you in the Treasury will issue bearer certificates in the foreign marketplace? Now, what is to prevent a U.S. citizen from being able to evade tremendous amounts of money, of tax obligations, when you open up this great avalanche of $1.4 trillion that you are going to be financing over there?

Mr. **Healey**. If it has not been made clear already, let me try to make it clear. In addition to what Mr. Pearlman said about the number of current U.S. financial instruments, including bank certificates of deposit, which are presently exempt from the withholding, you also have U.S. Treasury bills with a maturity of less than 6 months exempt from the U.S. withholding tax.

All I want to suggest is there is already a huge amount of available financial instruments that anybody desiring to commit tax fraud can use in order to commit tax fraud and to avoid paying the interest that he properly should under our tax laws.

Changing the withholding on the Treasury coupons is not going to allow any more avoidance, because there is already, unfortunately, too much opportunity for that. There is more than enough supply of securities.

Mr. **Jenkins**. But you are going to increase that. Otherwise, why would you be so insistent upon supporting withholding of interest on domestic savings accounts? The Treasury has taken the position that we are losing huge amounts of money because we have no withholding on interest here.

Mr. **Pearlman**. Mr. Jenkins, I do not think we would—I think we have concluded that it will not increase the potential for avoidance. It is quite possible, for example, that someone today that could buy a U.S. dollar-denominated foreign obligation might be more interested in buying a U.S. Treasury. That is possible, and in that sense there may be more interest in people going abroad and trying to evade tax.

Mr. **Jenkins**. Of course there will be. I would not want to go purchase a foreign obligation. However, if I can buy a U.S. obligation in Europe without having any withholding, obviously that is very attractive.

Mr. **Pearlman**. The important thing is to understand that that is possible today.

Mr. **Jenkins**. Six-month certificate.

Mr. **Pearlman**. No; the Eurodollar market, which permits AAA-rated U.S. corporate obligations to be sold only overseas.

Mr. **Jenkins**. U.S. corporate obligations. I am talking about U.S. securities now. You want to finance the debt and eliminate the withholding, as I understand it, for foreign purchasers.

Mr. **Pearlman**. It is quite possible that there will be taxpayers today who would only buy a Treasury obligation. I think that is what you are saying.

Mr. **Jenkins**. Yes.

Mr. **Pearlman**. And they would not go overseas if they had to buy something other than a Treasury obligation. There is no way for us to measure the extent to which that will happen. The data would suggest that people who are trying to evade U.S. tax have ample opportunity to buy highly rated and well collateralized obligations today.

But let me add, however, that even if you assume that there will be people who have an interest in going abroad and buying Treasury securities, but they would not buy anything else, that Congress did in 1982 enact provisions that are designed to restrict that ability. So Treasury will be required to comply with the same restrictions that are now imposed in Eurodollar transactions to try to assure that those obligations do not come back to the United States.

That is not to say that none of them will. We know that some of them will. But we think the rules that are in the law, that were enacted in TEFRA, are adequate to prevent that abuse. And if we find that that is not the case, then we will be back to Congress seeking additional strictures on those rules.

But those rules were carefully thought out and well designed, and we think they will work.

Chairman **Rostenkowski**. Mr. Downey will inquire.

Mr. **Downey**. Thank you, Mr. Chairman.

I want to deal with this question of whether or not U.S. citizens would have the ability for the same withholding treatment if they were purchasing foreign denomination certificates. In this regard, I think it is important to note that the Japanese—please correct me if I am wrong—impose a 20-percent withholding tax on interest earned by foreigners on yen-denominated assets, for the explicit purpose of keeping the yen from appreciating, to the disadvantage of Japanese exports.

And my understanding is that in recent negotiations the Japanese were adamant about keeping this tax in place, is that correct?

Mr. **Pearlman**. You are correct in your description of the current Japanese rules. There is a 20-percent withholding tax. There are discussions going on between our governments, right, but at this point there is simply nothing——

Mr. **Downey**. There are discussions going on with the Russians about the arms control agreements, but I would not bet the ranch on them.

Can I ask as well about the March 1980 issue of Euromoney. It noted that the U.S. banks and investment firms which advocate the repeal of the withholding tax hope that the repeal will enable them to earn commissions selling bonds to foreign buyers anxious to shelter themselves from their own tax burdens at home.

If I understand your answer, it is that they can already shelter themselves from this by using the Netherlands Antilles and other such devices. But now it would seem to me that with respect to Mr. Jenkins' questions, they will still be able to avoid taxation and that the United States will become the taxation for foreigners to avoid paying taxes in their own home country.

Is that a fair characterization?

Mr. **Pearlman**. Mr. Downey, the market in the rest of the world, particularly in Europe, has traditionally been a bearer obligation market. Whether it is because people are avoiding taxes at home, or as we think, it is because people in other parts of the world are more concerned about anonymity and are not quite as comfortable putting their name on an obligation, we do not know. We think that is the principal motive.

There are plenty of obligations, both U.S obligations and other obligations, available to those investors if they want to avoid tax in their home country.

Mr. **Downey**. But Mr Jenkins' point, it seems to me, was a fairly valid one. If I am given the opportunity between corporate securities and U.S. securities and I am fairly conservative, why would I not choose a U.S. Treasury security? I mean, after all, I cannot think of any safer investment offhand.

Mr. **Healey**. If you go back to the point 1 minute ago about the fact that you can already, if you wish to do that, you can already buy a 6-month Treasury bill that is exempt from the withholding and accomplish your purpose. There are billions and billions of dollars of those available to you. Unfortunately, there is no reason to assume that an increase in the supply is necessarily going to increase the supply of fraud.

Mr. **Downey**. May I ask you, with respect to our view of what the change in law would have on the exchange rate of the dollar. Do you have any studies, any indications of whether this will hurt or help our ability to export abroad? I understand the fact that we will be able to help finance the debt, but that may only further exacerbate the problem of exporting.

Mr. **Healey**. We have clearly looked at that issue and realistically would expect that there would be some net inflow of foreign capital, and we would expect that—it is difficult to trace with any precision exactly what result that would have. The first result would be at least some change in the composition of the flows as people rearrange their portfolio. Given that net capital inflows on the United States right now needed to finance our current account deficit somewhere on the order of $100 billion, are so large, we do not see any detectable change as a result of this legislation.

There are also a large number of other factors, economic policies of other countries, among others, that affect the balance of payments.

Mr. **Downey**. They answer to the question about the exchange rate is that you see no detectable difference with this legislation; is that true?

Mr. **Healey**. We would expect there would be some change, but it would be very modest.

Mr. **Conable**. Would the gentleman yield for a question on that?

Mr. **Downey**. Of course.

Mr. **Conable**. Is it not true that this capital from abroad is found capital? If it comes into our market, it is available to increase the supply of money available for borrowing, it has a tendency to reduce interest rates, and that is an offset against the inflow of money.

Mr. **Healey**. I think that is a good point.

Mr. **Downey**. I would just say to my learned colleague from New York that these matters are never quite so simple as to whether or not foreign capital in this country helps or hurts. It is a question of degree and kind and a whole host of other things. If the capital flows in and out quickly, it could have a very harmful effect on the Nation's economy.

I agree in general that there is nothing to say that foreign capital coming in here is in and of itself bad. The question is how long it stays and whether it is steady, continuous. I think it is also fair to say that if we did not have a $200 billion deficit that we have today, we might have less interest in this sort of legislation.

Chairman ROSTENKOWSKI. Mr. Frenzel will inquire.

Mr. FRENZEL. Thank you, Mr. Chairman, and thank you, gentlemen, for your testimony.

As I understand the situation, up until H.R. 4170 or its conference version passes, anybody who has some resources and can take the time, that is, big corporations, can avoid withholding by using a Netherlands Antilles connection, is that correct?

Mr. PEARLMAN. That is correct.

Mr. FRENZEL. And Mr. Gibbons assures us that the intent of his bill is to make that kind of borrowing available to companies large and small, even those of us that cannot afford to send people to the Netherlands Antilles to set up the arrangement

As I understand H.R. 4170, a provision of that relating to who can take what foreign tax credits probably is going to foreclose the use of the Netherlands Antilles for these kinds of things in the future, is that correct?

Mr. PEARLMAN. It will clearly, from what we can tell, foreclose the use of the international finance subsidiary Eurodollar transaction for some issues. But it is also clear that some Netherlands Antilles Eurodollar transactions will be able to continue even after the, assuming the enactment of H.R. 4170. For example, the U.S. corporation actively engaged in business overseas that is able to utilize the equity that it must maintain in its Netherlands Antilles subsidiary in its business abroad will really not be adversely affected by the other provisions to which you refer.

Mr. FRENZEL. Yes; but that would take a combination of circumstances that will not apply to all borrowers and will make access to capital markets uneven for the wide range of American companies.

Mr. PEARLMAN. That is correct, Mr. Frenzel, and that is indeed the reason that we support H.R. 3025 because it immediately eliminates the new restrictions on withholding and therefore will eliminate those uneven items that you mentioned.

Mr. FRENZEL. Unless this particular bill or some phase of it is passed and withholding is repealed or deferred or something, most American corporations will not have access to Eurobonds except at a premium price?

Mr. PEARLMAN. If you assume that no action is taken on withholding—and I think that is what you are assuming—then the other provisions contained in H.R. 4170 dealing with the foreign tax credit, are going to have an adverse impact on the ability of U.S. corporations to use the Eurodollar market. We think that is correct.

Mr. HEALEY. To be a little more specific, the nature of the Eurobond market and the people who purchase those securities under the current arrangements precludes that to all except a couple of hundred of the largest corporations in the United States. Everyone else, be it the Treasury on one side or all other corporations on the other, are effectively precluded by the nature of that market.

Mr. **Frenzel**. I agree. Mr. Gibbons' stated intention is to make this part of the credit market available to more U.S. companies, which seems to make sense to me. So if you use the Senate phasedown, does that not kill the operation for most borrowers?

In looking at a list which purports to be the basis points saved by Netherlands Antilles borrowers in the last 2 years, it seems as though there is a thin margin of advantage ranging from a few basis points in one instance to a little more than 100 basis points.

Does a tiny withholding tax make the use of those markets unattractive?

Mr. **Pearlman**. Mr. Frenzel, I think it certainly will in some instances. We have had difficulty in trying to quantify that, and we have indeed tried to do that. Certainly there will be some corporations with even a very modest withholding tax who will find it is not advantageous to use the Eurodollar market.

Mr. **Frenzel**. Well, it seems to me if some of us have access to that market, it ought to be, as Mr. Gibbons says, that all of us or almost all of us should have access to that market. It seems that the law presents discriminatory access for a very select number of companies and that you are then correct in trying to open it up to the broadest spectrum of American borrowers.

Is that part of your rationale?

Mr. **Pearlman**. That is very much our rationale.

Mr. **Frenzel**. Well, I thank you very much for your testimony, and I yield the balance of my time.

Chairman **Rostenkowski**. Mr. Stark will inquire.

Mr. **Stark**. Thank you, Mr. Chairman.

Mr. Pearlman, we have been negotiating with the Netherlands Antilles for a new tax treaty for a number of years, have we not?

Mr. **Pearlman**. We have for several years, that's right.

Mr. **Stark**. If we are going to allow them special treatment, why would it not be a good idea to make accepting a tax information exchange treaty part of that package?

Mr. **Pearlman**. Well, we do believe that exchange of information is an important part of our negotiations.

Mr. **Stark**. But what I am saying is if you are going to allow the Netherlands Antilles a special exemption from withholding, either phase it out or give them some special treatment, why not just write it into law that they must have a tax exchange treaty with us?

Mr. **Pearlman**. I do not understand your question. Excuse me. We think that exchange of information is important, so——

Mr. **Stark**. So if we added it to this bill you would support that as an addition?

Mr. **Pearlman**. Mr. Stark, let me say again that we really hope that the conferees will look more favorably on not a phasedown but an immediate repeal.

Mr. **Stark**. But if we had to phase it out, then we might as well get something back for that. Would you agree with that?

Mr. **Pearlman**. I would think we would be supportive of an exchange of information requirement.

Mr. **Stark**. And just as a side bar to that, are there any other countries besides Panama and the Bahamas who have not yet signed the exchange of information treaty because of this required in the CBI?

Mr. **Pearlman**. Yes, I think so.

Mr. **Stark**. Who else?

Mr. **Pearlman**. There have been no exchange of information agreements signed yet under CBI.

Mr. **Stark**. Is there any indication that the CBI countries are going to sign the exchange of tax information?

Mr. **Pearlman**. Yes, there is indication that some will, but the real question is how many. Discussions are going on now.

Mr. **Stark**. In the April 1984 issue of an international tax review magazine published by Price Waterhouse, and I want to quote:

> The main result of the exchange of information provision has been to give the Caribbean tax havens (and aspiring tax havens) a high visibility forum in which to assure the world that Yankee money cannot unseal their lips. To date results have been pretty much limited to letting the tax havens advertise their independence of Uncle Sam.

Would you say that is a pretty fair statement of our negotiations to date?

Mr. **Pearlman**. I am familiar with that article. I am not in a position to say that the CBI legislation did that. I think that, you know, we have had a problem over a long number of years in trying to accomplish more full exchange of information.

Mr. **Stark**. But that would help us collect the tax due us, would it not?

Mr. **Pearlman**. Exchange of information, yes.

Mr. **Stark**. And make it more difficult for drug and other criminals to launder money through the Caribbean nations, wouldn't that make that——

Mr. **Pearlman**. We view our exchange of information treaty program as very important.

Mr. **Stark**. So what I am getting at is this might be the time, as long as we are discussing this whole topic, to tighten that up and say, you know, no dessert, friends, unless you eat your spinach, which is you want some kind of loopholes, you want Caribbean Basin Initiative; let's exchange information.

Mr. **Pearlman**. Mr. Stark, let me add one point that I think is important because I don't want to leave a misimpression.

In our negotiations with the Netherlands Antilles, we found that country quite willing to discuss exchange of information, and we were——

Mr. **Stark**. But how many years have they been discussing it?

Mr. **Pearlman**. I would say that the progress that has been made——

Mr. **Stark**. Three, four?

Mr. **Pearlman** [continuing]. In the treaty recently has been very positive.

I simply do not want to leave the misimpression that there has been lack of cooperation.

Mr. **Stark**. But we could do it much more quickly if it were in the legislation, could we not?

Mr. **Pearlman**. I think you could.

Mr. **Stark.** I would be glad to yield to the gentleman.

Mr. **Downey.** You raise an interesting point here that I would like to explore with you.

It is conceivable that drug dealers now have a much more difficult process in laundering their money.

Is it possible that under this legislation they could simply purchase U.S. Treasury bearer bonds and avoid the difficulty of both taxation and laundering their money?

Mr. **Stark.** Well, no. I think it is my time, but in responding to the gentleman from New York, I think the Treasury has been in the position of issuing only book certificates at this point. There are no more, to my knowledge domestic Government bonds, notes, or bills available. They are all recorded and registered, so that if we now open up this very valuable avenue for illegal funds and skimming, the gentleman from New York's supposition is right. We could in fact open an avenue for laundering that does not now exist.

Mr. **Pearlman.** Let me add I do not think we would share that view.

Mr. **Downey.** I would be surprised if you did.

Mr. **Pearlman.** The launderers have not seemed to have a problem laundering money.

Mr. **Healey.** It is unfortunate, but there are still billions of dollars of pre-TEFRA bearer securities outstanding in the domestic market. We would love to do away with them overnight because of the laundering problem, but it does not seem to be feasible.

Mr. **Stark.** Do you have any idea what percentage of the coupons are coming out of places like Panama and the Netherlands Antilles? Have you done any studies to see how many coupons are redeemed offshore as opposed to domestically?

Mr. **Healey.** I cannot give you an answer to that question.

Mr. **Stark.** It would be an intriguing study, I think. Thank you.

Chairman **Rostenkowski.** Mr. Conable will inquire.

Mr. **Conable.** Well, I just want to make another statement. I hope people here will keep their eye on the ball. One of the things we want is foreign capital. Capital is what makes our system function. These other countries do not have withholding. If you want to launder money, you can launder money through foreign obligations. If you want to, there are lots of ways of doing that, but it seems to me that we ought to try to get access to foreign capital in whatever way we can. It is a valuable commodity for our economy. Our economy functions on capital, and the idea that we are doing a great favor for these people and that we ought to leverage it in some way in order to impose conditions on it in my view misses the whole point of what we are trying to do.

Mr. **Downey.** Will the gentleman yield?

Mr. **Conable.** Yes.

Mr. **Downey.** The Japanese have withholding.

Mr. **Conable.** All right, well, fine. Then they will not go to Japan, and Japan will have difficulty being——

Mr. **Downey.** The gentleman makes a point I think we all agree with, and that is that we want capital coming into this country.

The question is whether or not there are other treaty obligations and there are questions of reciprocity. This is not just a simple matter of saying we welcome all the capital.

Mr. **Conable**. But I would hate to see us failing to take a reasonable step so that we could use a lever on the Netherlands Antilles to get something that we have failed to be able to get as long as they have a privileged position.

Why in the world should we continue that privilege in order to lever them so that we can then discriminate against ourselves in getting access to the Eurobond market?

Mr. **Jenkins**. Would the gentleman yield?

Mr. **Conable**. Yes.

Mr. **Jenkins**. I agree with the gentleman on that part as far as the Antilles, but I think this bill goes much beyond that.

One question I have never had fully answered—and I have heard several members ask this—when you say that the other countries do not have withholding, do they have withholding on their own obligations, where they are owned by foreign citizens?

Mr. **Conable**. I do not know, but we elicit from Treasury a lot of information about the major European countries that do not require withholding on American investment there. I do not care if they do or not, frankly. If they want to require withholding and scare off American investors who otherwise would invest there, that is their business. I frankly would like to have them withhold so that Americans would be discouraged from investing in that kind of investment abroad, but I would also like to take steps here that would encourage foreign capital to come in here because I think that is going to help our system. It is found money. I want to repeat that.

Chairman **Rostenkowski**. Mr. Secretary, what would the impact be of a 3-percent withholding tax in lieu of a total repeal?

Mr. **Pearlman**. Mr. Chairman, I cannot give you a precise response. We have been told both by members of the investment banking community and it appears to us that it will have a discouraging effect on Eurodollar-type transactions, that is, that if you add even a very small amount of tax, that for the reason Mr. Frenzel gave, that because the lines are very fine, that the yield on the obligation will be such that the cost to a number of issuers will be too high to go into the foreign market. But I cannot quantify that for you and tell you the extent to which it will adversely affect the Eurodollar market.

Chairman **Rostenkowski**. Could you give us a revenue estimate as to just what the impact would be? Could your staff come back with that sometime late this afternoon?

Mr. **Pearlman**. We can certainly try. We will certainly try to give you that.

Chairman **Rostenkowski**. Mr. Guarini will inquire.

Mr. **Guarini**. Mr. Chairman, I think that what we are really getting down to here is compliance. I would suspect that Treasury would not want to have any percentage because there is a compliance provision.

Now, let me give you a hypothetical. If someone from this country here invests money in Treasury notes and U.S. securities overseas and he puts them in another person's name, there would be no record because there is no necessity to comply with any reporting provisions, is that correct?

Mr. **Pearlman**. Present law?

Mr. **Guarini**. That's right. A person has millions of dollars that he got in the illegal world, the syndicate or whatever you want, narcotics, and he puts it in a foreign person's name, he can buy foreign securities, and there would be no worry about compliance because there is no report that would have to be made under your version of the bill.

Mr. **Pearlman**. You are talking about a U.S. citizen?

Mr. **Guarini**. That's right, wanting to evade income tax or wanting to move money that he cannot ordinarily move.

Mr. **Pearlman**. If a U.S. person is able to take money overseas and invest it either in his own name or in someone else's name, the United States has no ability, has no jurisdictional ability to force some——

Mr. **Guarini**. That is right. However, under existing law, if he puts it in another person's name to avoid calling attention to himself, there would be a requirement of a report, a compliance report would have to be made because the foreign person is receiving interest, is that correct?

Mr. **Pearlman**. Does your question assume that the foreigner then reinvests in the United States?

Mr. **Guarini**. No; I am saying that an American buys securities in a foreign country and he puts the securities——

Mr. **Pearlman**. I don't think there would be any reporting under current law, and there would be no reporting under these bills.

Mr. **Healey**. That is the attraction of the Netherlands Antilles subsidiary, is that it escapes—any securities issued through that device escape the need for any kind of reporting, and so all of the corporate securities issued through NV subsidiaries today, whether it be General Motors or the World Bank or whoever—none of those have to be reported to the U.S. Government.

Mr. **Guarini**. Let's take a foreigner who has illegal money, and he wants to invest it in the United States. All right, now, there would be no way of any record being kept that he would not—that he would be free to do what he wants to do because he wouldn't be worried about the United States making a record which could be reported to the Internal Revenue Service.

Mr. **Healey**. If you go back to the example I used in my oral testimony, unfortunately, that is very easy for someone who wants to avoid that to do so. Using the position of owning a security for 179 days and trading it in to a dealer for 1 day on the coupon payment date, and then buying it back a day later makes an impossible situation of ever knowing that someone—ever policing or knowing that someone has done that, and gives today under current law and under current market situations any foreigner a total ability to avoid any kind of easy detection——

Mr. **Guarini**. But you help him avoid income tax in his own country or evade income tax in his own country because of that.

Mr. **Healey**. Well, the two do not necessarily follow. I mean, whether the United States collects a tax from that taxpayer——

Mr. **Guarini**. Yes, but a record is made and there is an exchange of information with the OIO or whatever it be.

You see, what we are trying to do is get at the treaties, and what we are doing in order to close the tax havens, we are opening the door wide open. We are saying there will be less compliance; the tax havens would even be more extensive than what they have had in the past. If it is the treaties that bother us, then I think we should get at the treaties. We should have more compliance. In this country we have an underground with $100 billion loss in our economy, with no compliance. The IRS only collects 56 percent of the capital gains from our own citizens, and here instead of tightening the requirements and talking about areas we should talk about, we are worried about whether or not big investment houses overseas are being taken care of, and I think that is the nature of this bill.

Chairman ROSTENKOWSKI. Are there any further questions?

[No response.]

Chairman ROSTENKOWSKI. If not, thank you very much. Mr. Pearlman, you will try to submit that information on the 3-percent withholding tax to me this afternoon.

Mr. PEARLMAN. Thank you, Mr. Chairman.

Mr. DOWNEY. Mr. Chairman, while you are calling the next witness, I just wanted to ask Mr. Conable and Mr. Gibbons, who have made the point about foreign capital, a question about the fact that when we ended our dependence on crude oil because we were worried about being dependent the level of dependence was much different. I mean, we took a much larger percentage of our energy supplies from foreign oil than we currently do.

Mr. CONABLE. But thank heavens we had that foreign oil when we needed it.

Mr. DOWNEY. I agree. But I just wanted to ask you, because I want to make it clear in my own mind, about where it becomes a problem to be dependent on foreign capital and where it does not become a problem, because both of you have seemed to make the argument that there is no downside to having foreign capital come into this country.

Mr. GIBBONS. There is a downside. These are American dollars that are owned by foreigners. They got over there by many ways. Primarily, we are putting them over there right now at the rate of better than $100 billion a year.

Now, they cannot come back to America unless—they cannot come back. There is no way for them to get back to America, so they are over there. They are in foreign possession, and the foreigner can lend them back here or he can lend them to the Japanese or he can lend them to any of our other trade competitors.

What we are trying to do is to get our hands back on some of our own dollars in a nondiscriminatory manner. The dollars did not go over there because there was a better investment environment over there. The dollars are over there because of our own doings.

We are borrowing back our own dollars, that is all we are doing, and that is the way they get back into our own hands. And we use them to help supply the capital need of our housing market and all of our other markets.

Chairman ROSTENKOWSKI. The Chair calls Mr. Anderson of the General Accounting Office.

Welcome, Mr. Anderson. If you are ready to proceed, the committee is ready to receive your testimony.

STATEMENT OF WILLIAM J. ANDERSON, DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JOHN GUNNER, GROUP DIRECTOR, INTERNAL REVENUE SERVICE AUDIT SITE, GAO; AND JOSEPH JOZEFCZYK, AUDIT MANAGER, GAO

Mr. **Anderson**. Thank you, Mr. Chairman. Good morning.

I am Bill Anderson, Director of the General Government Division of the GAO, and I would like to introduce the two gentlemen at the table with me before I proceed, sir. To my right is John Gunner. John is Group Director at our Internal Revenue Service audit site; and to my left is Joseph Jozefczyk. Joe was the audit manager on some of the work that we have been doing in this area.

I think an appropriate starting point would be to give you a little bit of the background on GAO's work in this area, sir. With your permission, I would like to have my full statement entered into the record and I will just make a brief summary statement.

GAO has been in this area now for a couple of years, primarily as a result of requests from the Subcommittee on Commerce, Consumer, and Monetary Affairs, both under Mr. Rosenthal and currently under Chairman Barnard. We have been looking at two facets of the situation: No. 1, IRS' tax administration of the withholding tax—a misnomer, withholding tax—that is based on certain remittances of U.S.-source income, primarily certain interest, royalties, dividends, et cetera. In addition, we have also been trying to assist the committee in work it is doing aimed at addressing some of the abuses associated with tax havens.

Now, to give you some of the context of the withholding tax we are talking about here, in 1981, probably the most current year in which complete data is available, we are talking about $9.6 billion of income that was remitted from the United States of the type we are concerned about here, $9.6 billion.

Of that, about $727 million of withholding tax, just a straight tax, was withheld. Included in that subtotal is about $3.3 billion of interest payments, including interest payments that we are concerned about here, of which about $95 million in tax was withheld.

Now, one of the reasons that Mr. Rosenthal and Chairman Barnard were concerned about this whole area and how they get into it initially was that it stood between the United States and correction of what was perceived as certain problems associated with the tax treaty with the Netherlands Antilles.

Specifically, the Antilles is a treaty tax haven, as opposed to a nontreaty tax haven, who pose a different sort of problem. But we were having no success at all in renegotiating this treaty with the Netherlands Antilles, because on the one hand the United States was getting a lot of benefit, it was perceived that the U.S. economy was getting a lot of benefit, by virtue of the ability of U.S. corporations to use the finance subsidiary route to access Eurobond moneys.

And so the initial initiative, at least over on that committee, in order to find alternative ways for U.S. corporations to access the Eurobond market was to improve the bargaining position of the United States with respect to renegotiating the treaty with the Netherlands Antilles. The problems with the Netherlands Antilles, by the way, are not documented. The tax abuse problems have not been effectively documented. There is a lot of anecdotal evidence.

I think that Chairman Barnard and the Subcommittee on Commerce, Consumer, and Monetary Affairs are convinced that we are talking about hundreds of millions of dollars of abuse. There is no hard evidence to support that. There is enough evidence, though, that there are problems of U.S. citizens and third country nationals, aside from the Eurobond situation, are abusing the treaty, the treaty privileges that we have with the Netherlands Antilles.

I should point out, by the way, that there are 28,000 shell corporations organized in the Netherlands Antilles, according to some information that we obtained.

Let me——

Mr. GIBBONS. 28,000?

Mr. ANDERSON. That is correct. I thought it was funny, but yes; 26,000, I'm sorry, 26,000.

Mr. GIBBONS. 26,000.

Mr. ANDERSON. Yes, information we had obtained from the people down there.

Now, in the course of developing the information that we have on this issue over the years, the two gentlemen with me, we have touched a lot of bases. We have been to the Antilles. We have spoken to tax officials in France, Switzerland, the Netherlands, as well as OECD. We have spoken to officials at IRS, Treasury, Justice, State, to get their perspectives on the importance of the treaty, as well as securities industry representatives, major banks, an extensive literature search, et cetera.

Now, let me kind of just speak of the pros and cons as we view it of the various alternatives that the committee is trying to chew on here. First, we have Gibbons-Conable and really the companion bill that was voted out of the Senate, S. 1557.

And I will be honest with you, sir: We are confused as to what the ultimate consequences of that would be. We have learned people on both sides that will come out, on the one hand, and say that there are great benefits to be achieved by the United States; and on the other hand we have a group of equally learned people come up here and tell us that all kind of dire consequences are going to follow as a result of this greater access of American borrowers.

I would point out that Chairman Volcker is perhaps another voice that should be consulted for some guidance on this. I understand that a lot of foreign central banks have some concerns about the effect of some of this legislation that would greatly—would open up access beyond U.S. corporations. I do not know what they might have to offer on it.

I sense, though, that there might be some other expert views that the committee would want to tap somewhere along the way.

I want to read one quote from a statement by Chairman Volcker earlier this month, sir:

> We simply cannot afford to become addicted to drawing on increasing amounts of foreign savings to help finance our internal economy. Part of our domestic industry, that part dependent on exports or competing with exports, would be sacrificed. The stability of the dollar and our domestic financial markets would become hostages to events abroad.

I do not pretend to be smart enough——

Mr. GIBBONS. He said that before my Trade Subcommittee. That is a quote. I had him here for that purpose.

Mr. ANDERSON. Yes, sir.

Mr. GIBBONS. I think he supports my position. I have not asked him, but——

Mr. GUARINI. We can read anything into what we want to. But I would suggest that there is some controversy.

Mr. GIBBONS. It is a little hard to understand how you can save money by eliminating a tax. I cannot understand that.

Go ahead.

Mr. ANDERSON. Yes, sir. I have not seen any definitive numbers on the impact of that, but I have seen numbers, I think produced by the securities industry, that indicated that we would be talking something perhaps $5 to $10 billion that would be directed into Treasury securities, and an offsetting reduction in the amount of money, all things being equal, that would have gone into corporate bonds.

I guess some of the analyses that I have read would lead one to believe that, rather than enhancing the ability of U.S. corporations to get access to moneys, this could constrain them a little bit. But again, that is the type of confusion that I think is going to have to be dealt with definitively in really deciding where the committee should come down on this.

I would now speak to Chairman Barnard's bill, H.R. 4029, which obviously just finds an alternative conduit or mechanism for U.S. corporations to continue to access the Eurobond market and in effect increases considerably our leverage for bargaining purposes with the Netherlands Antilles.

I know, as you are well aware, that arguments have been raised to mitigate the effect on the Netherlands Antilles of removing this source of revenue to them. I know the people at the State Department feel strongly, the people we spoke to feel strongly, that the Netherlands Antilles is a friendly nation and that eliminating the income that is associated with these offshore financing activities would have a rather drastic impact on that country.

I do not know what the answer to that is, sir. Obviously, I can see an analogy with tax expenditures. You are paying it one way or the other. You might as well be up front if you are going to provide them that type of assistance, and if you vote it, fine; if you do not, so be it.

But in any event, it is a consideration. I think we do not have an opinion on it, a GAO position on any of the pieces of legislation, sir, beyond what I have said already. There are just too many uncertainties regarding the beneficial, alleged beneficial and alleged harmful effects of Gibbons-Conable.

Let me stop right there and we will try to respond to any questions you may have, you and the other members may have.

[The prepared statement follows:]

STATEMENT OF WILLIAM J. ANDERSON, DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Committee, we are pleased to be here to assist the Committee in its deliberations over proposed revisions to the statutory 30-percent withholding tax on U.S.-source interest income paid to foreigners. Our testimony is based on work we have done during the past 2 years on several international tax issues. In particular, we have analyzed the potential for abuse of the U.S-Netherlands Antilles tax treaty, and we have compared the U.S withholding tax system to the systems operated by several other countries.

In so doing, we gathered and analyzed data on U.S.-source income paid to foreign investors and information on the U.S. withholding tax on that income. We have also discussed the issue of U.S. corporate access to the Eurobond market with officials from the Departments of the Treasury and State, the Internal Revenue Service (IRS), and representatives of the securities industry.

As you know, Mr. Chairman, the U.S. generally imposes a statutory 30-percent tax on various types of income such as interest, dividends, rents, and royalties paid to foreign investors. The tax is withheld at source by withholding agents such as banks, brokerage firms, and corporations. However, the tax may be reduced or eliminated if the income recipient claims residence in a country which has a tax treaty with the United States.

Through our work, we identified three factors which the Committee needs to consider in its deliberations over the U.S. 30-percent withholding tax:

First, U.S. corporations make extensive use of the Eurobond market to finance their business operations. As a practical matter, current U.S. corporate access to the Eurobond market depends entirely on the unique relationship between the existing U.S. tax treaty with the Netherlands Antilles and the domestic laws of that country.

Second, offshore financial activities have grown in their importance to the economy of the Netherlands Antilles. That growth occurred to some extent with the actual or tacit approval of the U.S government.

And third, the U.S. tax treaty with the Netherlands Antilles has been subject to abuse by third-country persons and perhaps by U.S. citizens. For several years now, Treasury has been trying to renegotiate the treaty to prevent such abuses. However, negotiations have not yet proven successful.

In part because Treasury has found it difficult to reach agreement with the Netherlands Antilles on a new tax treaty, the Congress is now in the position of having to make a difficult decision which may have far-reaching effects. In our view, the Committee has at least five potential alternatives from which to choose, ranging from seeking to maintain the status quo to immediate repeal of the 30-percent withholding tax. Before elaborating on each alternative, I would like to provide the Committee with some background information.

U.S. CORPORATIONS MAKE EXTENSIVE USE OF THE EUROBOND MARKET

Over the past several years, U.S. corporations have frequently turned to the Eurobond market to borrow funds. This is because the market has represented a large pool of available funds which sometimes can be borrowed at rates lower than those available in the U.S. According to securities industry representatives, when U.S. corporations take advantage of the Eurobond market, they generally pay about one-half of the one percent less in interest charges than would be the case in the domestic U.S. bond market.

According to securities industry data, U.S. corporate reliance on the Eurobond market as a source of long-term debt financing increased steadily from 1974 to 1982, declining somewhat in 1983. During calendar years 1980 through 1983, the Eurobond market was the source for about 15 percent of the funds raised through bond issues by U.S. corporations. In its peak year—1982—the $14.6 billion borrowed on the Eurobond market by U.S. corporations represented 28 percent of the $52.1 billion in total domestic and foreign bond offerings by U.S. corporations.

Thus, the Eurobond market has become an important source of capital for U.S corporations. And the Chairman of the Federal Reserve, in testimony before the House Committee on Banking, Finance and Urban Affairs in February 1984, said that most forecasts suggest that the U.S. will have to borrow extensively abroad this year to meet projected funding needs. Eurobonds, of course, need supply only a portion of these funds because foreign investment also can enter the U.S. in other ways, such as through bank deposits and purchases of Treasury securities by certain parties. Generally, these types of foreign investments already are, by law, exempt from U.S. withholding tax. Nevertheless, Eurobonds are expected to serve as a major source of funds for U.S. corporations this year.

Given that, Mr. Chairman, I think it would be helpful to briefly discuss how U.S. corporations now gain access to the Eurobond market through the Netherlands Antilles.

GROWTH OF NETHERLANDS ANTILLES OFFSHORE FINANCIAL ACTIVITIES

In 1955, the United States' tax treaty with the Netherlands was extended to the Netherlands Antilles, a country composed of six islands in the Caribbean. Subsequently, the Netherlands Antilles amended its internal law so as to encourage third-country persons to invest money through the Antilles.

At that time, as compared to the present, there was only limited U.S. corporate activity in the form of international borrowing. But corporations nonethless desired to develop a means for gaining access to foreign capital at costs which sometimes could be lower than those paid for U.S.-source borrowings. During the early 1960's, the U.S. government decided that providing for such access would be in the best interests of the nation's economy.

Accordingly, IRS began issuing private letter rulings to corporations stating that, under certain conditions, the U.S. statutory 30-percent withholding tax would not apply to Eurobond borrowings by offshore finance subsidiaries of U.S. corporations. Specifically, IRS ruled that the negotiated tax treaty rate of zero would apply to interest payments between the two countries. Because Antillies law placed only a small domestic tax on the activities of finance subsidiaries, that country became the most popular base for such entities.

The popularity of finance subsidiaries dclined somewhat in 1971, however, with the U.S. decision to abondon fixed exchange rates. And questions arose as to the need for an exemption from the 30-percent withholding tax for corporate overseas borrowings. IRS decided at that point to cease issuing private letter rulings exempting overseas borrowings from the tax and, as a result, the popularity of such borrowings declined.

In 1974, however, a U.S. law firm issued an opinion which held that the U.S. 30-percent withholding tax did not apply to certain forms of overseas borrowings. IRS did not challenge that legal opinion and, subsequently, the process of obtaining a similar legal opinion for each overseas offering became standard practice among corporate borrowers.

At this point, Mr. Chairman, it might be helpful to describe the basic operations of a Netherlands Antilles finance subsidiary of a U.S. corporation. A finance subsidiary essentially is a shell company which acts as a conduit for U.S. corporate overseas borrowings. The shell company in the Antilles generally floats a bond issue in a European financial market (typically in London) and the borrowed funds simply "pass through" the Antilles en route to U.S. or foreign subsidiaries of the U.S. parent corporation. Subsequently, interest payments on the bonds made by the parent corporation may flow out of the U.S. tax-free through the Antilles to foreign investors.

To illustrate the significance of U.S. finance subsidiaries, one only has to look at IRS statistics concerning U.S.-source investment income paid to foreigners. About $3.4 billion in taxable-type U.S.-source interest was reported as paid to foreign persons in 1981. About $1 billion, or 29 percent, of the $3.4 billion was paid to individuals or businesses claiming residence in the Netherlands Antilles. This made Antilles' residents the leading world-wide recipients of U.S.-source interest income in 1981. It should be noted, however, that the $3.4 billion does not reflect all of the U.S.-source interest income earned by foreigners. This is because certain types of U.S.-source interest income are not subject to the statutory U.S. 30-percent withholding tax and are not reported to IRS.

Data available from IRS for 1982 indicates that $5.2 billion—an increase of $1.8 billion—in taxable-type U.S.-source interest income was paid to foreigners that year. Of this amount, almost $1.5 billion, or 29 percent, was paid to individuals or businesses claiming Antilles residence.

Also, the finance subsidiaries of U.S. corporations generate important tax revenues for the Netherlands Antilles. The tax imposed by the Antilles on offshore finance activities generates about $150 million in revenues annually for that country, according to Antilles representatives. And the importance of those revenues has increased over the past several years as the other major sectors of the Antilles' economy—tourism, oil refining, and ship repair and servicing—have declined. As a result, according to Antilles representatives, offshore financing activities now generate about 25 percent of that country's national tax revenues. The loss of these activities would have a significant economic impact on the Netherlands Antilles.

Concerning the latter point, a State Department official told us that any further weakening of the Antilles' economy could lead to political instability. The official further noted that the Netherlands Antilles has been a strong ally of the U.S. for many years and that it is strategically located near an area where oil reserves are known to exist. Moreover, the U.S. and Antilles governments recently reached agreement on a mutual assistance treaty for law enforcement matters in general. According to Justice Department officials, the Antilles provides U.S. law enforcement agencies with valuable information concerning drug trafficking between South America and the United States.

Given the benefits being realized by American business and the federal government from our present relationship with the Netherlands Antilles, a question arises as to why there is a need for the Congress to address the issue of the 30-percent withholding tax at this time. The answer lies primarily in the fact that there has been some documented, and much alleged, third-country and U.S. citizen abuse of the U.S.-Netherlands Antilles tax treaty. The Department of the Treasury has neither been able to reach agreement with the Antilles on a new treaty, nor willing to terminate the existing treaty with that country.

TAX TREATY ABUSES

In order to make advantageous use of the U.S. tax treaty with the Netherlands Antilles, a third-country investor must first incorporate a company in that country. Forming a company is not a difficult task, and such a company can be used as an effective conduit for a variety of investments.

Once a company has been formed in the Netherlands Antilles, the investor may proceed to take advantage of that country's treaty network, particularly the treaty with the United States. Although there are several different kinds of Netherlands Antilles companies, some of the more important types are real estate companies and investment companies. The following are examples of how third-country investors can use such companies to benefit from the U.S. tax treaty with the Netherlands Antilles.

A real estate company is used primarily to channel funds into U.S. real property, such as apartment buildings and shopping centers. Foreign investors can invest funds directly in U.S. real estate. But rents and royalties arising from such investments generally are taxed at the 30-percent rate. Also, any captial gains would be subject to tax. By structuring such investments through a Netherlands Antilles company, however, an investor can avoid the 30-percent withholding tax. Furthermore, such investors currently are able to avoid U.S. tax on any capital gains arising from their investments.

Like a real estate company, an investment company is used primarily to channel funds into the United States. Investment companies, however, generally are used to pruchase securities, such as corporate stocks. Again, foreign investors can invest directly in U.S. security markets. In so doing, however, the investor typically encounters the U.S. 30-percent withholding tax. But again, by structuring such transactions through a Netherlands Antilles company, an investor can use the tax treaty to reduce or avoid that tax.

Use of such companies is not limited to third-country residents. In fact, it would also be relatively easy for a U.S. citizen to evade U.S. tax through use of a Netherlands Antilles company. To do so, with virtual assurance of anonymity, the U.S. citizen needs only to start by establishing a shell company in a tax haven country. Then the shell company can form a Netherlands Antilles company and proceed to take advantage of the tax treaty through investments in the United States.

For several years now, the Department of the Treasury has been seeking to renegotiate the U.S. tax treaty with the Netherlands Antilles in order to incorporate stronger anti-abuse and exchange of information provisions. Antilles negotiators, however, believe that Treasury perceives a need to maintain a treaty relationship so as to assure continued U.S. corporate access to the Eurobond market. This has made it difficult for Treasury to obtain a final agreement with the Antilles in a new, more effective treaty. Treasury has also been reluctant to terminate the present treaty or the ongoing negotiations.

As a result, the Congress now has been put in the position of having to deal with these problems. In so doing, it will have to choose from among several alternative courses of action and thereby address a series of related issues.

ALTERNATIVE COURSES OF ACTION

There are at least five ways through which to address the issue of U.S. corporate reliance on the Eurobond market. That is, the Congress could—

Decide to take no legislative action, thereby seeking to maintain the status quo;

Eliminate foreign tax credits for payments made by subsidiaries of U.S. corporations to the Antilles government;

Enact H.R. 4029 which removes the 30-percent withholding tax on Eurobonds;

Enact that portion of H.R. 2163 which phases out the 30-percent withholding tax over a period of years; or

Enact H.R. 3025 which immediately repeals the 30-percent withholding tax.

In choosing from among these options, the Congress necessarily will address issues relating to U.S. corporate access to the Eurobond market, the economy of the Netherlands Antilles, and tax treaty abuses.

SEEKING TO MAINTAIN THE STATUS QUO

The first option I would like to discuss involves seeking to maintain the status quo. This would entail (1) retaining the Antilles treaty, at least as it applies to the finance subsidiaries of U.S. corporations and (2) continuing to allow foreign tax credits for tax payments made to the Antilles. This approach will permit continued U.S. corporate access to the Eurobond market at favorable interest rates; it will also maintain indirect U.S. support for the Antilles economy.

But the Antilles would have no additional incentive to conclude a new tax treaty with the U.S. which would curb treaty abuse by third-country and U.S. persons. Moreover, U.S. taxpayers would continue to subsidize a major part of the costs associated with U.S. corporate use of Antilles finance subsidiaries. This is because the taxes paid by U.S. corporations to the Antilles presently can be credited against the corporations' U.S. tax liabilities.

ELIMINATING FOREIGN TAX CREDITS

A second alternative would be to eliminate the aforementioned foreign tax credits, thereby reducing or effectively eliminating the incentive for U.S. corporations to access the Eurobond market through the Netherlands Antilles. Currently, tax payments made by finance subsidiaries to the Antilles may generally be claimed as credits on a dollar for dollar basis against the U.S. parent corporation's tax liability. If U.S. corporations were denied these tax credits, tax payments made to the Antilles would presumably continue to reduce the U.S. parent corporation's tax liability—but not on a dollar for dollar basis. Instead, the tax liability would be reduced at a percentage rate equal to the corporation's marginal tax rate.

According to several securities industry representatives, elimination of the foreign tax credit generally would have the effect of offsetting some of the interest savings available on the Eurobond market. Although we cannot attest to the accuracy of that assertion, there is little doubt that U.S. corporations would have reduced incentives to use the Netherlands Antilles for access to that market. The reduced incentives would also place Treasury in a better position to renegotiate the tax treaty with the Antilles or terminate the existing treaty to eliminate abuses.

But this alternative would have serious, negative effects on the Netherlands Antilles' economy. This is because the Antilles would receive significantly reduced tax revenues from the operations of U.S. corporate finance subsidiaries. Further, if Treasury were to decide to terminate the treaty, revenues derived by the Antilles from real estate companies, investment companies, etc., would be reduced as well.

ELIMINATING THE U.S. WITHHOLDING TAX ON EUROBONDS

A third option is to adopt H.R. 4029 which would remove the U.S. 30-percent withholding tax only on U.S. corporate bonds issued on the Eurobond market. U.S. corporations could then directly access the Eurobond market at favorable rates, thus eliminating the need for reliance on Netherlands Antilles finance subsidiaries.

H.R. 4029 would not, by itself, solve the problem of Antilles-relatd tax treaty abuses. However, by eliminating the need for U.S. companies to go through the Antilles, it would remove the most significant impediment to solving that problem. It would do this by putting the Department of the Treasury in a better position to conclude a revised tax treaty or, if necessary, to terminate the existing treaty. This alternative, too, would have an immediate, negative effect on the Netherlands Antilles' economy.

PHASING OUT THE WITHHOLDING TAX ON EUROBONDS AND REGISTERED SECURITIES

H.R. 2163 offers a fourth alternative approach. It would provide for broader access to foreign capital markets than would H.R. 4029. In this regard, H.R. 2163 would exempt both U.S. corporate Eurobond issues and registered securities, such as Treasury bonds, from the 30-percent withholding tax.

The withholding tax, however, would be phased out over several years. This would be accomplished by immediately reducing the 30-percent tax to 5 percent. The tax would then be reduced by one percentage point each year until July 1, 1988, when it would be eliminated.

With respect to U.S. corporate access to the Eurobond market, tax treaty abuses, and effects on the Antilles' economy, adoption of the approach set forth in H.R. 2163 ultimately would have some effects similar to those associated with H.R. 4029. That is, once the tax has been phased out, the following could occur:

U.S. corporations no longer would find it advantageous to rely on Netherlands Antilles finance subsidiaries.

Treasury would be in a stronger position with respect to treaty negotiations with the Antilles.

The economy of the Antilles would be negatively affected, unless it developed new money-making initiatives during the phase out period to replace the revenues derived from its offshore finance activities.

One important difference between the two bills is that, under H.R. 2163, all affected parties—the securities industry, the Treasury Department, and the Netherlands Antilles—would have several years to prepare and plan ways in which to adapt to a revised Eurobond financing system.

A second and perhaps more important difference between the two bills is that, besides affecting Eurobond financing methods, H.R. 2163 could also have the effect of opening up U.S. capital markets by removing the withholding tax on registered securities as well as on Eurobonds. This could have far-reaching and, as yet, unpredictable effects on international capital markets. It could also directly affect the tax policies of other countries. For example, tax authorities from France told us that, if the U.S. were to eliminate its 30-percent withholding tax on interest, they also would have to consider eliminating their withholding tax. They would have to do so in order to remain competitive with the U.S. in attracting foreign investment.

IMMEDIATE REPEAL OF THE 30-PERCENT WITHHOLDING TAX

Like H.R. 2163, H.R. 3025 would eliminate the U.S. 30-percent withholding tax on both Eurobonds and registered securities. It differs from H.R. 2163, however, in one major way—it repeals the tax immediately rather than phasing it out over a period of years.

H.R. 3025 would immediately facilitate U.S. corporate access to the Eurobond market and would put Treasury in a stronger negotiating position with the Antilles. But H.R. 3025 would have an immediate, negative effect on the economy of the Antilles. This is because, unlike H.R. 2163, H.R. 3025 offers no phase-out period and thus affords the Antilles no interim time period during which to adjust to the impending loss of tax revenues. Furthermore, H.R. 3025 could also have immediate and unpredictable effects on capital markets and on the tax policies of other countries.

In sum, Mr. Chairman, this Committee and, indeed, the Congress as a whole face a more difficult task. Each of the options presently before you involve unknowns. In that respect, the least predictable of the options in terms of their effects are H.R. 3025 and H.R. 2163. More predictable are the effects of H.R. 4029. Even so, the data available are not sufficient for us to give you the "ideal" answer.

This concludes my prepared statement. We would be pleased to respond to any questions.

Mr. STARK. Thank you, Mr. Anderson.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

Congressman Barnard made a statement a while back that the Netherlands Antilles tax treaty actually was costing the U.S. Treasury at least $1 billion a year. Would you care to comment on that?

Mr. ANDERSON. Yes, sir. I think that Chairman Barnard would be the first to concede that that $1 billion is a very soft number. On the other hand, there have been sufficient instances, documented instances where abuse has been detected involving U.S. citizens, involving drug smugglers, other types of criminals, to know that a lot of it goes on.

It is there. Secrecy is guaranteed. It is so easy to go to one of the non-treaty-tax havens, such as the Caymans or somewhere, establish a shell organization of some type, which in turn can open another shell corporation in the Netherlands Antilles, and all at once you have access to the legitimate world.

The opportunities are there and I can assume they are being utilized in some fashion. The magnitude of it, though—I think that Chairman Barnard would not stand behind his $1 billion too hard, but I think there are a lot of indications that it could be significant in amount.

Mr. **Duncan**. He is to testify next. We will ask him.

What would be your reaction if we gave Guam the same authority to issue the Eurobonds that the Netherlands Antilles has?

Mr. **Anderson**. To me, sir, it certainly seems like a circuitous route to satisfy the borrowing needs of American corporations. I will be honest with you. That is a personal opinion. I mean, I have no problem at all——

Mr. **Duncan**. Or is it just a closed shop and you want to keep it the way it is?

Mr. **Anderson**. No, sir; I do not think that—I can see a need to try to eliminate, to try to eliminate the type of abuses, tax abuses that are occurring by virtue of the treaty-tax haven status of the Netherlands Antilles. There is a need to fix some of that through improved disclosure provisions.

It was encouraging to hear what Treasury had to say this morning, that the Netherlands Antilles is becoming more forward in that regard. But the status quo, I think we would agree with Chairman Barnard, is unacceptable.

Mr. **Duncan**. Well, what are we doing about it? We are just condoning it and going along with the abuse?

Mr. **Anderson**. We have been doing that for about 4 or 5 years now, sir. I think it was in about 1979, as I understand it, when we first started trying to renegotiate our way—started trying to renegotiate the treaty with the Netherlands Antilles.

But as long as we had that seemingly greatly needed benefit of facilitated access by U.S. corporations to the Eurobond market, our bargaining hand was constrained considerably.

Mr. **Duncan**. Thank you, sir.

Thank you, Mr. Chairman.

Mr. **Stark**. Mr. Anderson, in your statement you said that U.S. corporations frequently turn to the Eurobond market to borrow funds. Large corporations, small corporations, all corporations? Which type?

Mr. **Anderson**. As I look at the list, it looks like they are all from the Fortune 500, sir. In fact, I can run down some of the representative names: McDonalds Corp., Citicorp, ITT, Sears, J.C. Penney—I will leap down the list—Merrill Lynch.

Mr. **Stark**. You have a list? What is the list, a study you have done?

Mr. **Anderson**. No, sir, this is a study that was done by the Securities Industry Association.

Mr. **Stark**. Could we have a copy to make it part of the record?

Mr. **Anderson**. Yes, we will provide the entire document.

[The material follows:]

Statement of

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On Behalf of the

Securities Industry Association
On S. 1557

Before the

United States Senate
Committee on Finance

September 19, 1983

Summary Statement of the Securities Industry Association on S. 1557 before the United States Senate Committee on Finance

We are appearing before the Senate Finance Committee in our capacities as members of a special sub-committee of the Securities Industry Association whose primary objective is the preservation of access to overseas capital markets by United States borrowers.

We are concerned that events might occur which could result in termination of future access to overseas capital markets and/or prepayment of $32 billion of overseas financings completed by U.S. corporations since 1974. We are aware that the U.S. Treasury Department is renegotiating the United States/Netherlands Antilles Tax Treaty. Separately, the Internal Revenue Service which had long approved the use of Netherlands Antilles subsidiaries, has recently raised certain questions about the application of withholding tax to interest paid on Eurobonds. The SIA is concerned that the foregoing administrative developments, absent enactment of S. 1557, could produce severe financial consequences.

The SIA supports S. 1557 and wishes you to focus your attention on the size of overseas capital markets, the degree of U.S. corporate involvement in them and the extent to which continued access to those markets is in this nation's self-interest. We also concur with the Treasury's conclusion that S. 1557, if enacted, will have a positive effect on tax revenues.

Continued access by U.S. borrowers to overseas fixed-income investors is of vital interest to this nation's financial health and both S. 1557 and a suitably renegotiated U.S./Netherlands Antilles Tax Treaty could attain this objective. Of the two alternatives, S. 1557 is the broader and the only one which would both facilitate capital flows into the United States and result in a net increase in U.S. tax revenues.

As well, S. 1557 would tend to integrate the U.S. and Eurodollar capital markets under U.S. influence and create employment opportunities in this country's financial services sector.

* * *

My name is Michael H. Coles and I am a Partner of Goldman, Sachs & Co. With me are Robert L. Loverd who is a Managing Director of The First Boston Corporation, Nicholas A. Rey who is a Managing Director of Merrill Lynch White Weld Capital Markets Group, John C. Evans who is an Advisory Director of Morgan Stanley & Co., Incorporated and John T. Shinkle who is General Counsel for Salomon Brothers Inc.

We appreciate this opportunity to appear before the Senate Finance Committee and are here in our capacities as members of a special subcommittee of the Securities Industry Association which has as its primary objective the preservation of access to overseas capital markets by United States borrowers. In addition to our firms, Morgan Guaranty Trust Company participates in the sub-committee in the capacity of an interested observer and is represented by Walter A. Gubert who is a Vice President of the bank. Combined, these six firms lead managed 99 of the 133 dollar-denominated Eurobond issues completed by U.S. corporations in 1982.

We appear here to testify in favor of S. 1557 which was introduced by Messrs. Chafee and Bentsen and would eliminate the 30% withholding tax on interest paid to foreign portfolio investors in U.S. bonds and foreigners who lend us money on a long term basis. There is of course no tax on interest paid to foreigners who lend us short term money. We view S. 1557 as a means of significantly expanding access to overseas investors on the part of U.S. borrowers, and we support it in that context. We are aware of the Treasury Department's estimate that S. 1557 would produce a revenue gain of some $35 to $50 million and we believe that the estimate is reasonable and conservative. Currently, American companies raise money abroad free of withholding tax by using Netherlands Antilles subsidiaries. Should S. 1557 not be enacted, it is imperative that this form of access to foreign investors be maintained by means of a revised United States - Netherlands Antilles Tax Treaty or otherwise.

Current Law

Under current law, the United States imposes a tax of 30% on interest payments made to foreign investors. This tax is collected in its entirety by withholding it at its source and is therefore called a withholding tax. Although the 30% rate may be reduced by existing tax treaties, such treaties as a practical matter are not relevant for debt obligations publicly offered outside the United States.

American debt obligations, burdened with this tax, must compete with securities sold in the Eurodollar bond market which are not subject to any so-called withholding tax.* The net effect of the U.S. tax, in most cases, would be to reduce the return to overseas investors on interest-bearing securities issued in the United States by up to 30%. This reduced return would make United States Government and corporate obligations decisively uncompetitive with alternative investments available in the Eurodollar bond market. The tax has created an insurmountable barrier to investment in United States Government and corporate debt securities by most foreign private individuals and institutions. As a practical matter, therefore, debt securities cannot be sold to foreign private sector investors if they are subject to the 30% withholding tax.

Although direct access to overseas investors is effectively precluded by the 30% withholding tax, U.S. corporations have been able to sell their debt securities outside the United States free of the withholding tax by means of indirect access through Netherlands Antilles subsidiaries. Netherlands Antilles subsidiaries have been employed for this purpose for almost 20 years. Funds raised by U.S. corporations in this manner amounted to $14.6 billion in 1982, up from $4.4 billion in 1980 and $1.5 billion in 1978; since 1974, over $32 billion of such overseas issues have been completed by U.S. corporations.

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* See the discussion of the withholding tax practices of other countries on page 7.

The Securities Industry Association Position

We are concerned that events might occur which would inadvertently result in the termination of future access to overseas capital markets and/or the prepayment of the approximately $32 billion of overseas issues which have been completed by U.S. corporations since 1974. We are aware that the U.S. Treasury Department is presently renegotiating the United States/Netherlands Antilles Tax Treaty. Separately, the Internal Revenue Service which had long approved the use of Netherlands Antilles subsidiaries, through its district offices has recently raised certain questions with regard to the application of withholding tax to interest paid on Eurobonds. This activity on the Service's part could have a substantial and adverse effect on U.S. corporations which have outstanding Eurobonds, and on future borrowings in the Eurobond market. The SIA is concerned that the foregoing administrative developments, absent enactment of S. 1557, could produce severe financial consequences.

The SIA supports S. 1557 and wishes to focus your attention on the size of overseas capital markets, the degree of U.S. corporate involvement in them and the extent to which continued access to those markets is in this nation's self-interest. We also concur with the Treasury's conclusion that S. 1557, if enacted, will have a positive effect on tax revenues.

Importance of Access to Capital Markets Outside the United States

The attached eight exhibits highlight the growth and current size of capital markets outside the United States and detail their increasing importance as a source of financing for American borrowers. If S. 1557 were not passed and if a suitable alternative means of accessing the Eurobond market free of withholding tax (such as a Netherlands Antilles subsidiary) were not available, overseas capital markets would be closed to future offerings by U.S. corporations and the following scenario might unfold:

- Domestic capital markets would experience severe pressures. For instance, had the $14.6 billion of Eurobond issues completed during 1982 been sold instead in the domestic market, new issue volume in the latter market would have increased 33% from $43.7 billion to $58.3 billion. We believe that this supply could not have been absorbed in an orderly manner. In a sense, therefore, overseas markets have functioned during recent years as an effective means of reducing pressure on domestic markets.

- The impact of these events would be particularly disruptive if pressures from the funding of present and future needs were combined at a point in time with the necessity of refunding the $32 billion of outstanding issues (see the last bullet point on the fifth page).

- As many U.S. corporations which financed in the Eurobond market during recent years were of extremely high credit quality, their return to the United States could tend to squeeze lower quality issuers out of domestic markets.

- The increase in the private sector's domestic funding activities would be in direct conflict with those of the U.S. government as it attempts to finance its budgetary deficit.

- It is highly unlikely that any significant portion of overseas investment funds which would otherwise have been employed for the purchase of Eurobond obligations of U.S. corporations would find their way back to the United States. A portion of such funds might be temporarily deposited with banks. However, shortly thereafter they would be invested in the debt obligations of those non-U.S. issuers which have free access to international capital markets.

- The net impact of this scenario would be that U.S. capital markets would experience severe volatility and that domestic interest rates would settle at levels above those which would otherwise prevail. Moreover, certain U.S. corporations would have diminished access to domestic capital markets.

In the event that U.S. withholding taxes were imposed on interest payments on presently outstanding Eurobond issues, the following events might occur:

- Most of the $32 billion of Eurobond issues sold since 1974 would be prepaid by their issuers. Otherwise, these same corporations would be legally obliged to gross up their interest payments on outstanding Eurobond issues by as much as 43%.

- Initially, these prepayments would be financed in U.S. dollars largely through bank loans and the issuance of commercial paper, primarily in the United States but also overseas. This would result in upward pressure on short term interest rates in the United States.

- The balance sheet liabilities of impacted U.S. corporations would, by historical standards, reflect a sharp increase in short term debt and an equivalent decrease in long term debt. This would occur at a time when the short term debt to total debt ratios of U.S. corporations are at historically high levels – levels which have in part caused major American rating agencies to downgrade the credit ratings of many corporations.

- To restore their balance sheet equilibrium, corporations probably would seek to refund their Eurobond issues with new domestic bond issues. As many of the offerings completed between 1974 and 1979 bear low coupons by today's standards, the interest expense of these corporations would increase (certain of the corporations with lower credit ratings might find it impossible to finance in domestic public or even private markets). While the refunding of issues completed during the 1980-82 high interest rate era might be completed at lower interest rates, such refundings would deprive overseas investors of their investment returns and could be expected to materially jeopardize relationships between the United States and the overseas investment community.

- Domestic capital markets would experience severe dislocations and interest rates would, at least for a time, move sharply upward.

- To put the $32 billion (plus accrued interest) refunding requirement in context, the average annual new issue volume of taxable fixed income securities in domestic capital markets in the 1979/82 period was $39 billion. Therefore, the refunding alone would be equivalent to almost one full year's activities in domestic capital markets.

Importance of Encouraging Capital Inflows to U.S. Capital Markets

In 1982, foreign investors were the source of $17.2 billion of net purchases of Treasury and federal financing bank bonds and notes; in the same year, foreign net purchases of U.S. corporate securities was a mere $1.6 billion. Our experience suggests that the vast majority of these investments were made by foreign central banks which are exempt from U.S. withholding taxes. Private sector investors (as opposed to central banks) tend to be the principal purchasers of corporate securities; we believe that their absence from the U.S. corporate market is due to the existence of the U.S. withholding tax coupled with the availability of attractive investment alternatives outside the United States. Thus, S. 1557 would remove the most important obstacle to capital inflows.

While potential incremental flows in a non-withholding tax environment cannot be predicted with any precision, surveys performed several years ago by Merrill Lynch and Morgan Stanley estimated incremental flows into Treasury and corporate securities of at least seven billion dollars. These figures do not necessarily constitute the *net* incremental flow to American borrowers which would result were U.S. withholding taxes eliminated. Were S. 1557 passed, it is likely that a significant portion of the $14.6 billion of funds raised by U.S. corporations in capital markets outside the United States in 1982 would not have been funded in that manner. Rather, most of those corporations would have elected to raise capital through SEC-registered offerings which would be sold, in part, to overseas investors. Thus, it is possible that under S. 1557, U.S. corporations would cut back on their new issue activities overseas and substitute for them domestic offerings which are sold in part to the same overseas investors which could have purchased the Eurobond issues.

Withholding Tax Practices Outside the United States

Debt obligations sold in the Eurobond market are invariably free of taxes withheld at the source. This freedom from withholding taxes may be based on a specific exemption for interest on specified foreign borrowings (as, e.g., in the case of Canada, France, the United Kingdom and Australia), on the absence of any withholding tax on interest (as, e.g., in the case of the Netherlands, Denmark and Finland) or on the use of foreign finance subsidiaries (as, e.g., in the case of Germany). Foreign countries whose issuers have borrowed in the Eurobond market without withholding tax include the following:

Algeria
Argentina
Australia
Austria
Brazil
Belgium
Canada
Chile
Columbia
Costa Rica
Denmark
Finland
France
Germany
Greece
Hungary
Iceland
India
Indonesia
Israel
Iran
Ireland
Italy
Japan
Kirea
Luxembourg
Malaysia
Mexico
Netherlands
New Zealand
Norway
Papua New Guinea
Philippines
Portugal
Singapore
South Africa
Spain
Sweden
Switzerland
Trinidad & Tobago
Thailand
United Kingdom
Venezuela
Yugoslavia

Borrowers in the Eurobond market also include international organizations (such as the World Bank and the Asian Development Bank) and multinational organizations (such as the European Investment Bank and the European Economic Community).

Revenue Enhancing Aspects of S. 1557

The SIA believes that S. 1557 will encourage the flow of foreign capital into the United States and will also result in a net increase in tax revenues to the United States. Regarding the latter subject, in a letter to the Hon. Sam M. Gibbons dated May 23, 1983, John E. Chapoton, Assistant Treasury Secretary for Tax Policy stated that "direct issuance of Eurobond obligations by U.S. issuers, as envisioned by your proposal, would result in a net gain in U.S. revenues" and that "the net revenue gain from such an amendment to the Internal Revenue Code would on a conservative basis be $35 million, and could well be as much as $50 million."

The SIA has on its own considered the potential revenue gain which would result from enactment of S. 1557. By making the employment of Netherlands Antilles finance subsidiaries unnecessary, enactment of S. 1557 would eliminate payments of Netherlands Antilles income tax made by such subsidiaries which, in turn, would eliminate the foreign tax credit taken for such taxes and thereby increase U.S. tax revenues. The magnitude of the revenues thus raised is difficult to quantify with certainty, largely because the Netherlands Antilles income tax varies with the finance subsidiary's debt to equity ratio, use of proceeds and other factors. Notwithstanding these information constraints, the SIA believes that the Treasury Department's estimate of a $35-50 million revenue gain is reasonable and conservative.

Existing Withholding Tax Uncertainties

The present environment is one in which a number of private sector borrowers are reluctant to take advantage of the net-cost-of-money savings and to exploit other opportunities available in capital markets outside the United States because of the uncertainty related to the future withholding tax status of interest payments on such obligations. This uncertainty is attributable to (a) the unknown status of S. 1557, (b) the renegotiation of the U.S./Netherlands Antilles Tax Treaty and (c) the Internal Revenue Service challenges to the tax status of certain existing Netherlands Antilles subsidiaries.

Equally important is the fact that for policy reasons a number of very important sectors of the economy have been deprived of access to the vast funds available outside the United States. In particular, the Federal National Mortgage Association, which has publicly stated its eagerness to tap those markets, has been denied the opportunity to do so. Moreover, the world's single largest issuer of coupon securities, the United States Treasury, is precluded by the U.S. withholding tax from directly attracting foreign private sector investors.

Conclusion

The SIA believes that continued and broadened access on the part of U.S. borrowers to overseas fixed income investors is of vital interest to this nation's financial health and that both S. 1557 and a suitably renegotiated U.S./Netherlands Antilles Tax Treaty could attain this objective. Of the two alternatives, S. 1557 is the broader and the only one which would both facilitate capital flows into the United States and result in a net increase in U.S. tax revenues. As well, S. 1557 would tend to integrate the two principal dollar capital markets (the domestic market and the Eurodollar market) under U.S. influence, with the result that more Americans would find employment in this country's financial services sector.

Thank you.

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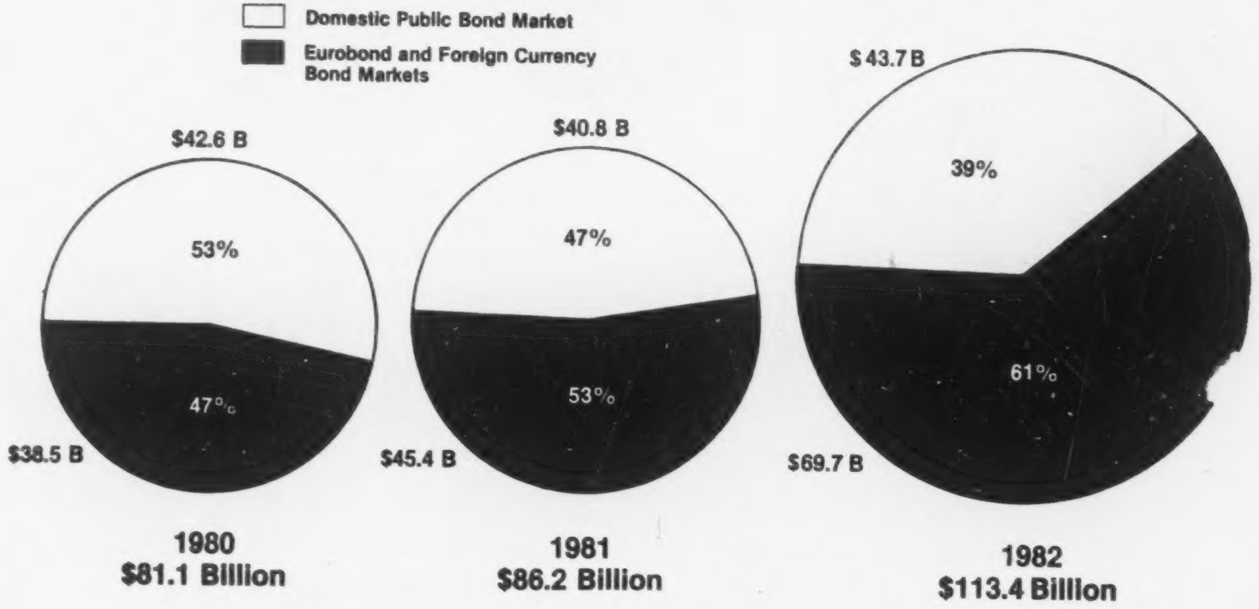
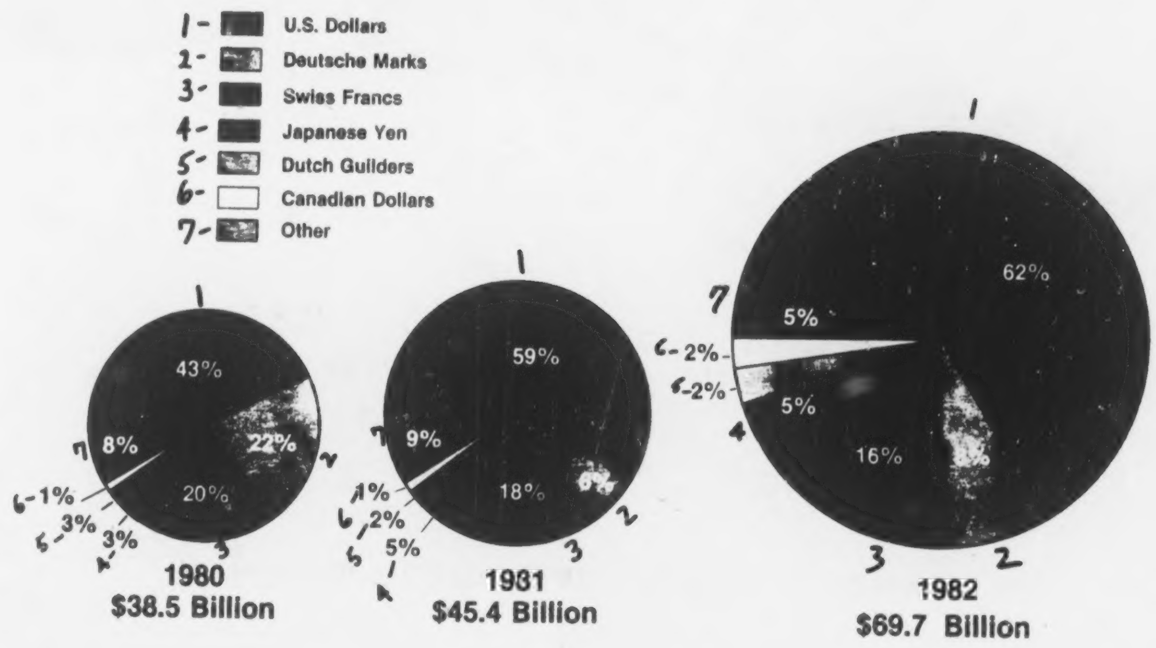
Principal Capital Markets of the World

Overseas capital markets accounted for 47% of funds raised in 1980 and 61% of a much enlarged market in 1982. Conversely, the domestic market shrank from 53% in 1980 to 39% in 1982.



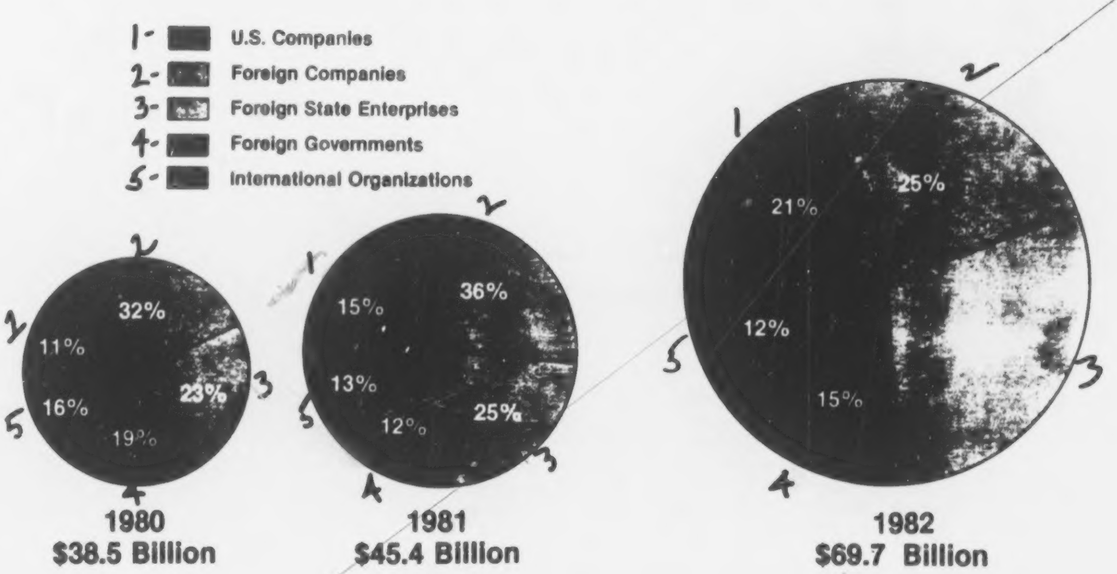
Eurobond and Foreign Currency Bond Market by Currency of Denomination

Between 1980 and 1982, total new issue volume in the Eurobond and foreign currency bond markets grew 81% and the share of U.S. dollar denominated issues increased from 43% to 62%.



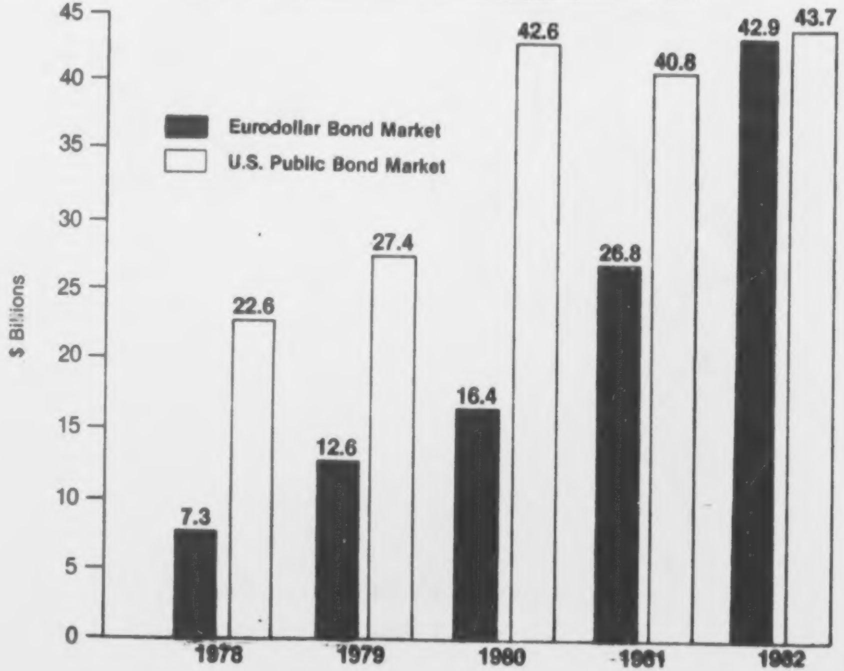
Nature of Borrowers in the Eurobond and Foreign Currency Bond Markets

U.S. issuers represented 11% of new issue volume in 1980 and 21% in 1982.



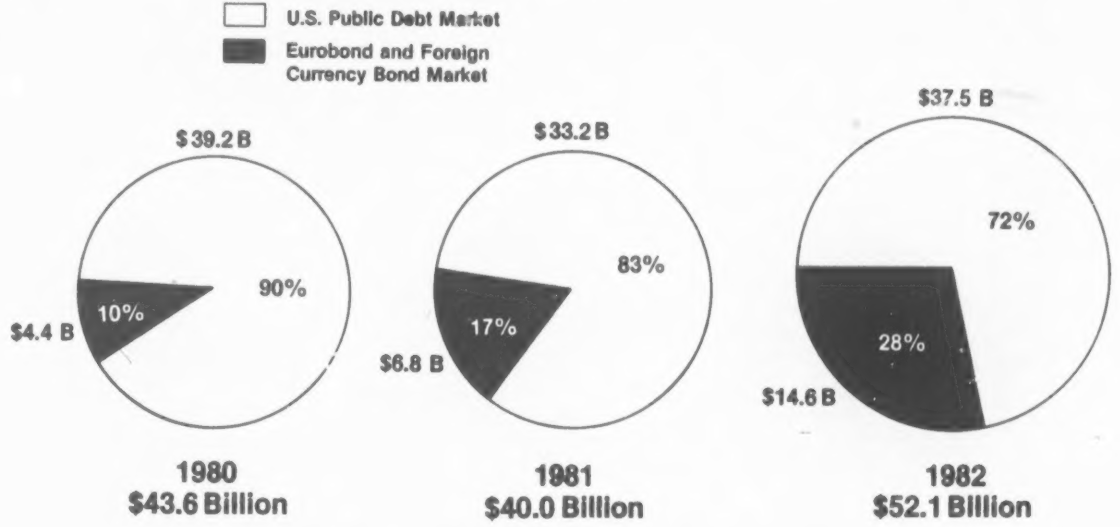
New Issues by All Borrowers in the U.S. Public and Eurodollar Bond Markets

Although for many years domestic new issue markets were 2 or 3 times the size of their overseas counterparts, in 1982 for the first time the two markets were approximately the same size.

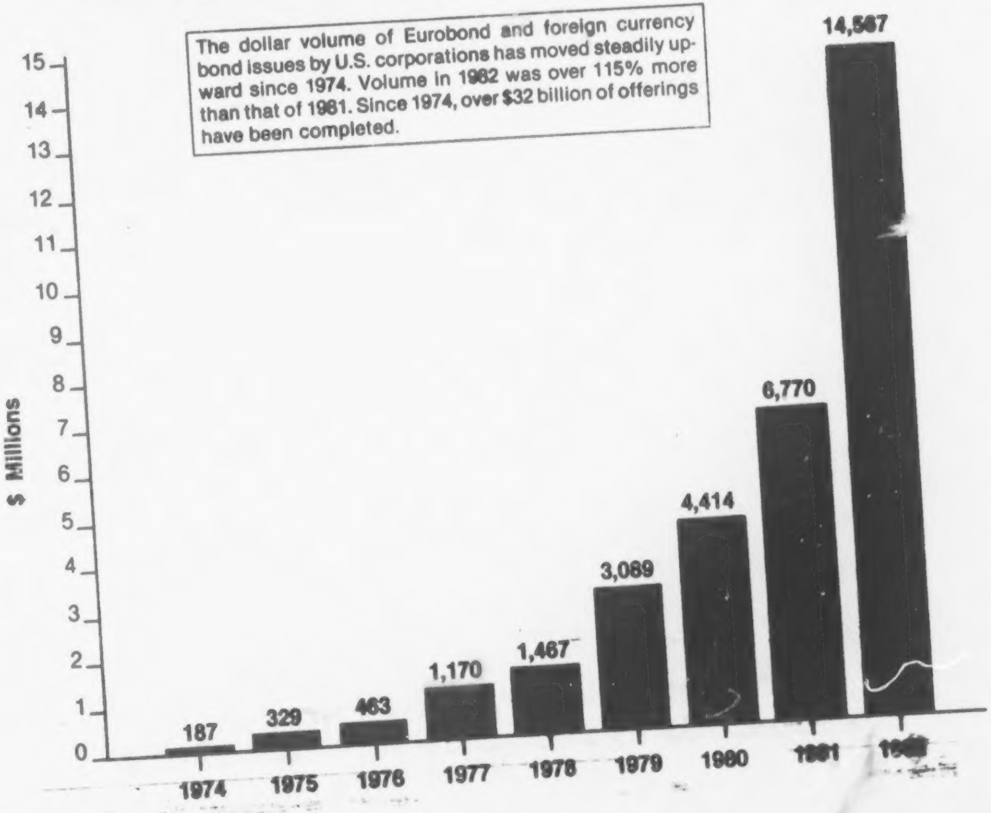


New Issues by American Corporations in the U.S. and Overseas Markets

Overseas capital markets have accounted for an increasing percentage of U.S. corporate public debt financing. In 1982, approximately 28% of public debt financing by U.S. corporations was completed in capital markets outside the United States.



Overseas Issues by U.S. Corporations



The dollar volume of Eurobond and foreign currency bond issues by U.S. corporations has moved steadily upward since 1974. Volume in 1982 was over 115% more than that of 1981. Since 1974, over $32 billion of offerings have been completed.

U.S. Corporations Which Have Utilized The Dollar Sector of the Eurobond Market

(January 1975 - December 1982)

A substantial number of U.S. companies have turned to the Eurodollar bond market as an alternative to the U.S. public market.

	Number of Issues	Dollar Volume (in millions)
Aetna Life and Casualty Company	1	150.0
Alaska Interstate	1	40.0
Alco Standard Corporation	1	30.0
Amax Inc.	1	75.0
American Airlines, Inc.	1	55.0
American Express International Banking Corp.	1	40.0
American Express Overseas Credit Corporation	1	75.0
American Medical International, Inc.	3	475.0
American Natural Resources Company	1	50.0
American Telephone & Telegraph Company	1	400.0
Anacomp Inc.	1	12.5
Anheuser - Busch, Inc.	2	200.0
Anixter Brothers Inc.	1	20.0
Apache Corporation	2	50.0
Arizona Public Service Co.	5	270.0
Armco Inc.	1	50.0
Ashland Oil, Inc.	1	60.0
Atlantic Richfield Company	2	700.0
Avco Corp.	2	45.0
Baker International Corporation	2	265.0
Bankers Trust New York Corporation	1	200.0
Bank of America	2	300.0
Beatrice Foods Co.	2	350
Beneficial Corporation	3	300
Blocker Energy Corporation	1	25.0
Burroughs Corporation	1	50.0
CPC International Inc.	1	50.0
Campbell Soup Company	2	250.0
Carolina Power & Light Company	1	60.0
Carter Hawley Hale Credit Corp.	1	50.0
Caterpillar Tractor Co.	3	540.0
The Charter Company	1	50.0
Chase Manhattan Corporation	1	150.0
Chemical New York Corporation	1	150.0
Citicorp	15	2,651.5
Cities Service Co.	1	150.0
City Investing Co.	2	80.0
Coca-Cola Bottling Company of New York Inc.	1	30.0

	Number of Issues	Dollar Volume (in millions)
The Coca-Cola Company	1	100.0
Commercial Credit Corporation	1	50.0
Community Psychiatric Centers	2	30.0
The Continental Group, Inc.	1	100.0
Continental Illinois Corporation	3	450.0
Crocker National Bank	1	225.0
Crutcher Resources Corporation	1	30.0
Digicon Inc.	1	18.0
Walt Disney Productions	2	175.0
Dow Chemical Co.	1	200.0
Dresser Industries, Inc.	1	75.0
Duke Power Company	1	60.0
Dynalectron Corporation	1	15.0
E.I. duPont de Nemours	6	1,315.0
ENSERCH Corporation	1	50.0
Esterline Corporation	1	20.0
Fairchild Camera and Instrument	1	20.0
First Chicago Corporation	1	100.0
First National Boston Corporation	1	100.0
Fluor Corporation	2	150.0
Ford Motor Company	2	450.0
Ford Motor Credit Company	3	450.0
Fruehauf Corp.	1	20.0
Fuqua Industries Inc.	1	50.0
Galaxy Oil Company	1	15.0
Galveston-Houston Company	2	30.0
Gearhart-Owen Industries Inc.	1	30.0
General Electric Credit Corporation	6	1,800.0
General Foods Corporation	1	100.0
General Motors Acceptance Corp.	15	2,275.0
General Motors Corporation	2	200.0
General Telephone & Electronics Corporation	7	350.0
Georgia-Pacific Corporation	1	65.0
Getty Oil Company	1	125.0
Goodyear Tire & Rubber Company	1	75.0
Gould Inc.	2	70.0
W.R. Grace & Company	1	75.0
Gulf States Utilities Company	2	120.0
Gulf Oil Corporation	4	675.0
Gulf & Western Industries, Inc.	4	135.0
The Hertz Corporation	1	50.0
Helmerich & Payne, Inc.	1	60.0
Hexcel Corporation	1	10.0
Hospital Corporation of America	2	105.0
Household International, Inc.	1	100.0
Huffy Corporation	1	10.0
IC Industries, Inc.	4	220.0
INA Corporation	2	100.0
IU International Corp.	2	65.0

	Number of Issues	Dollar Volume (in millions)
Illinois Power Company	1	50.0
Ingersoll - Rand Co.	1	50.0
International Business Machines Corp.	5	660.0
International Harvester Co.	1	115.0
International Standard Electric Corporation	1	100.0
International Telephone & Telegraph Corporation	1	75.0
Itel Corp.	2	55.0
John Hancock Mutual Life Insurance Company	1	75.0
J.P. Morgan & Co. Incorporated	1	250.0
K - Mart Corp.	2	136.0
Kansas Gas and Electric Company	1	40.0
Kay Corporation	2	35.0
Kennecott Corp.	1	100.0
Kidde, Inc.	1	50.0
Lear Petroleum Corporation	2	70.0
Lifemark Corporation	1	25.0
MGF Oil Corporation	1	35.0
McDonnell Douglas Corp.	2	90.0
McGraw - Edison Co.	1	75.0
Manufacturers Hanover Corporation	3	300.0
Marine Midland Banks, Inc.	1	125.0
Marion Corporation	1	20.0
Massey - Ferguson Inc.	2	115.0
Marriott Corp.	1	12.5
Merrill Lynch & Co., Inc.	2	200.0
Miles Laboratories, Inc.	1	20.0
Mobil Oil Corporation	1	500.0
Montana Power Company	2	100.0
Moran Energy Inc.	1	50.0
NICOR Inc.	1	50.0
Natomas International Corporation	3	150.0
Newmont Mining Company	1	50.0
The New York Times Company	1	50.0
Niagara Mohawk Power Corp.	1	50.0
Northern Indiana Public Service Co.	1	50.0
Northwest Energy Company	1	40.0
Northwest Industries, Inc.	1	50.0
Northwest Natural Gas Company	1	40.0
Oak Industries	1	35.0
Occidental Petroleum Corp.	7	350.0
Ohio Edison Co.	2	125.0
Optical Coating Laboratory Inc.	1	15.0
Pacific Gas & Electric Co.	3	180.0
Pacific Lighting Corp.	1	65.0
Pembroke Capital Company Inc.	2	300.0
Pengo Industries Inc.	1	22.5
J.C. Penney Company, Inc.	4	650.0
Pennwalt Corp.	1	25.0
Pennzoil Corporation	1	75.0

	Number of Issues	Dollar Volume (in millions)
Pepsico, Inc.	5	475.0
Philip Morris Credit Corporation	1	200.0
Phillips Petroleum Company	1	200.0
Portland General Electric Co.	2	100.0
Prudential Funding Corporation	1	150.0
Public Service of New Hampshire	1	30.0
Reading & Bates Corp.	1	25.0
Republic Steel Corp.	1	100.0
R.J. Reynolds Industries, Inc.	3	560.0
Reynolds Metals Company	1	60.0
The Saint Paul's Companies, Inc.	1	75.0
Santa Fe International Corp.	2	50.0
Sears Roebuck and Co.	4	1,050.0
Security Pacific Corporation	1	100.0
The Singer Company	1	50.0
South Carolina Electric & Gas Co.	1	80.0
Southern California Edison Co.	6	375.0
Southern California Gas Supply Co.	1	50.0
Spectra-Physics, Inc.	1	15.0
Sperry Corporation	1	100.0
Standard Oil Co. (Indiana)	1	75.0
Sundstrand Corporation	2	45.0
The Superior Oil Company	2	225.0
Tenneco Inc.	2	200.0
Texas General Resources, Inc.	1	12.0
Texas International Airlines, Inc.	3	90.0
Tosco Corporation	1	50.0
Trailer Train Co.	1	40.0
Transamerica Corp.	2	125.0
Transco Companies	2	100.0
Trans-Western Exploration Inc.	1	10.0
Tribune Co.	1	50.0
Triton Oil & Gas Corp.	1	20.0
Tyco Laboratories	2	32.0
U.S. Leasing International, Inc.	1	20.0
Union Carbide Corporation	1	150.0
Union Camp Corporation	1	70.0
United Technologies Corporation	1	100.0
Varco International Inc.	1	20.0
Jim Walter Corporation	1	25.0
Wang Laboratories, Inc.	1	40.0
Walt Disney Productions	2	175.0
Warner-Lambert Company	1	100.0
Wells Fargo & Co.	4	325.0
Xerox Corporation	1	100.0
Xerox Credit Corporation	1	250.0
Xidex Corporation	1	20.0

Cost Savings in the Eurodollar Bond Market

(1983)

Major U.S. Corporations have issued Eurobonds to raise capital at attractive rates relative to the U.S. domestic market.

Offering Date	Guarantor	Amount ($ Millions)	Net Cost of Money Savings Versus Domestic Market* (in basis points)
11/23	Security Pacific Corporation	100	14
11/23	McDonalds Corporation	75	58
11/16	Citicorp	100	40
11/10	ITT Financial Corporation	125	80
11/07	Sears Roebuck & Co.	125	63
10/21	Texaco Inc.	200	94
9/26	Sears Roebuck & Co.	150	38
9/22	General Motors Acceptance Corporation	100	88
9/20	J.C. Penney Company Inc.	100	37
9/20	Pacific Gas & Electric Company	75	46
9/12	Citicorp	100	37
7/21	J.P. Morgan International Capital	150	40
6/13	Levi Strauss & Co.	75	18
6/07	Richardson-Vicks Inc.	125	10
6/02	Revlon, Inc.	125	17
5/25	Security Pacific Corporation	100	20
5/04	Manufacturers Hanover Corporation	100	39
4/22	Citicorp	100	49
4/15	Southern California Edison Company	75	37
4/12	Enserch Corporation	100	0
4/11	Merrill Lynch & Co. Inc.	200	36
3/15	Crocker National Bank	75	12
3/08	Honeywell Inc.	100	28
3/04	American Express Overseas Credit Corporation Ltd.	100	51
2/23	Prudential Funding Corporation	100	45
1/19	McDonalds Corporation	75	104
1/14	General Electric Credit Corporation	100	119
1/14	Texaco Inc.	150	82
1/13	Avon Products Inc.	100	69
1/13	Sears Roebuck & Co.	150	42
1/13	General Motors Acceptance Corporation	200	32
1/11	Security Pacific Corporation	100	58
1/11	The Coca Cola Company	100	102
1/07	The Continental Group Inc.	75	3
1/05	Time Incorporated	100	27

*The indicated savings compare the net cost of money on the Eurobond issue with what would have been the estimated net cost of money for an instrument of identical maturity and size in the U.S. domestic public market.

Offering Date	Guarantor	Amount ($ Millions)	Maturity (Years)	Net Cost of Money Savings Versus Domestic Market* (in basis points)
8/12	Pacific Gas and Electric Company	60	8	47
8/06	General Motors Acceptance Corporation	100	6	36
5/19	The Superior Oil Company	125	7	57
5/19	Illinois Power Company	50	7	59
5/17	Northwest Natural Gas Company	40	10	14
5/14	First National Boston Corporation	100	7	73
5/12	General Motors Acceptance Corporation	100	5	18
5/05	General Motors Acceptance Corporation	125	7	30
4/26	Union Carbide Corporation	150	7	31
4/23	Southern California Edison Company	75	7	63
4/16	Getty Oil Company	125	7	106
4/15	Phillips Petroleum Company	200	7	74
4/15	The Hertz Corporation	50	7	15
4/07	Campbell Soup Company	50	7	100
4/06	Bank of America NT and SA	200	5	89
3/30	Gulf States Utilities Company	60	8	78
3/25	Pacific Gas and Electric Company	45	7	53
3/10	American Telephone & Telegraph Company	400	7	46
2/19	Continental Illinois Corporation	100	7	14
2/11	Arizona Public Service Company	25	7	69
2/10	General Motors Acceptance Corporation	150	6	42
2/10	McDonnell Douglas Finance Corporation	50	7	8
1/26	Arizona Public Service Company	75	7	111

*The indicated savings compare the net cost of money on the Eurobond issue with what, in the SIA sub-committee's best judgment, would have been the net cost of money for an instrument of identical maturity in the domestic public market.

Illustrative Cost Savings in the Eurodollar Bond Market

1982

In addition to diversifying their funding sources, many corporations have tapped overseas markets because dollar funds were available on a lower cost basis than domestically.

Offering Date	Guarantor	Amount ($ Millions)	Maturity (Years)	Net Cost of Money Savings Versus Domestic Market* (in basis points)
11/18	Arizona Public Service Company	60	7	55
11/18	General Foods Corporation	100	12	44
11/17	Bank of America Corporation	100	7	108
11/17	Gulf Oil Corporation	100	12	99
11/16	E.I. du Pont de Nemours	100	12	51
11/11	Coca Cola Company	100	5.5	15
11/10	General Electric Credit Corporation	200	7	79
11/10	Warner-Lambert Company	100	7	43
10/19	Superior Oil Company	100	10	83
10/18	Southern California Edison Company	75	8	20
10/12	The New York Times Company	50	5	19
10/04	United Technologies Corp.	100	7	29
10/01	Dresser Industries	75	7	20
9/21	Walt Disney Productions	75	7	86
9/21	Gulf Oil Corporation	100	5	49
9/21	Prudential Funding Corporation	150	5	16
9/20	Coca-Cola Company	100	7	117
9/10	General Electric Credit Corporation	100	7	149
9/10	RJ Reynolds Industries, Inc.	100	7	97
9/09	IBM World Trade Corporation	200	10	63
8/17	Southern California Gas Corp.	50	7	24
8/16	Sperry Corporation	100	7	26

Mr. STARK. Who generally purchases the Eurobonds?

Mr. ANDERSON. There is no certain information on who the purchasers of Eurobonds are. There is just apparently a strong belief that it consists much more of individuals than the type of institutional investors that you would associate here in the United States in our bond market, and a large number of those out of Switzerland.

Mr. STARK. OK. Besides the high rate of return, what other factors do you think impact on the Eurobond purchaser?

Mr. ANDERSON. Well, I think the anonymity, the fact that it is bearer paper, we understand has a lot to do with the attractiveness to the type of investors that seek them out.

Mr. STARK. What would you guess, if you had to guess? How much of that, how many of those anonymous purchasers would you guess are U.S. citizens?

Mr. ANDERSON. You know, I can only think of one number I have ever seen that might even give an indication in that direction. This goes back, I think, to the 1960's. The IRS arranged to have mail coming from Switzerland from Swiss banks—they did a scan of it back in those days, and they tried to see who were the Americans who were getting mail from Swiss banks of all types.

Then they triggered some audits of some of those people, just to see what happened. And about 20 percent of them were involved in some type of income that they were using to avoid the payment of U.S. taxes by virtue of having a Swiss account.

So there is some of it going on, undoubtedly. People obviously will find a way to evade taxes.

Mr. STARK. One final question. You have heard or are aware of a variety of options and proposals involving this whole issue. What option would you pick?

Mr. ANDERSON. As I said, sir, the ultimate merit, I think, of Gibbons-Conable has yet to be established. I would like to get a wider range of views on it. That in fact may be the best way to go.

Absent certain knowledge about the ramifications of that on the U.S. economy, U.S. business, I would opt for something like Chairman Barnard's bill. I might comment to the committee, maybe it wants to think a little bit about the effect of the legislation on the Netherlands Antilles.

Mr. STARK. The committee might be more disposed to think about that effect if we had a tax information exchange treaty with them. It is easier to think about it with that treaty in place than it is without a treaty in place.

Does somebody else want to comment on that?

Mr. GUNNER. Mr. Congressman, I believe that if we were to provide a means for U.S. corporations to have access to the Eurobond market, that would remove the primary obstacle to Treasury either concluding a treaty that would include exchange of information or, as it has done with some other countries, terminating the treaty if necessary.

Mr. STARK. Thank you.

Mr. Downey.

Mr. DOWNEY. No questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. Thank you, Mr. Chairman.

Does the GAO subscribe to the concept that if you hesitate or are in doubt do not do it at all?

Mr. **Anderson.** I am sorry?

Mr. **Guarini.** If you hesitate and you doubt what the premise is, perhaps you should not do it at all?

Mr. **Anderson.** Yes, sir; that sounds like good basic wisdom.

Mr. **Guarini.** Let me ask you, where is the small businessman that much better off? Is it not a matter of sophistication? You are only dealing with numbers, and there are some people that could be professional people or business people, that could be small business people, with enough knowledge of how international monetary matters work to avail themselves of these same rules and regulations that a large corporation does, isn't that true?

Mr. **Anderson.** Yes, sir.

Mr. **Guarini.** When they are dealing with Eurodollars and they are dealing with offshore accounts and tax havens?

Mr. **Anderson.** There is probably some minimum amount in the type of offering you are talking about where you could penetrate the market. But obviously, that expertise could be there as well.

Mr. **Guarini.** Yes; but it is not a matter of the rules favoring big corporations. It is just that they happen to have tax lawyers and accountants that know more what to do than the smaller individual.

But the point was made that this bill favors and helps small business people. Is that a fact? That is what I am trying to establish?

Mr. **Anderson.** I am going to say a word to that and then turn it over to Mr. Gunner to my right here. I think that that kind of depends on what the consequences of the bill would be.

In other words, if one of the consequences, in fact, was to divert Eurodollars to Treasury securities, that could, in effect, reduce the amount of money otherwise available to American business. I would say larger corporations could find it tougher, much less smaller corporations.

Mr. **Gunner.** Mr. Guarini, I think another factor I did not hear mentioned earlier is that European investors, in moving money over here to the States, would be concerned about the safety of the corporation issuing the debt instrument. A large corporation obviously is much safer than smaller companies. I would question whether some European investor would want to invest, for example, in bonds of a biotech company.

Mr. **Guarini.** So it would discourage investing in American corporations and would encourage Europeans investing in Treasury notes?

Mr. **Anderson.** It could have that effect.

Mr. **Guarini.** So that would be counterproductive to what we want to achieve, in a sense. It would not go into capital formation.

Mr. **Anderson.** That is one of the problems.

Mr. **Guarini.** Would it strengthen or weaken the dollar if a rule like this went into effect? And one of the big problems we have, is that we had a $70 billion trade deficit and next year we are facing a $110 billion trade deficit, which is putting millions of Americans out of work.

Would that not strengthen the dollar?

Mr. ANDERSON. It should tend to increase the demand for dollars on world markets, hence pushing up the value. Marginally, though, I mean, in terms of the dollars, that is right.

Mr. GUARINI. But it would be in that direction?

Mr. ANDERSON. Yes, sir.

Mr. GUARINI. And our allies are very upset about the international interest rates that they blame the United States. Would this then not crowd out the money that is available on the worldwide money market and create a tendency toward interest rates inching up worldwide?

Mr. ANDERSON. That is correct, sir. And I mentioned earlier that certain other foreign central banks we understand would be opposed to a move in this direction.

Mr. GUARINI. And we have many treaties that are in existence now. The Netherlands Antilles Treaty is up for review. But what impact would it be on our relationships with all those other foreign countries that are involved? Would that cause an economic imbalance and perhaps problems that could be visited upon our allies with whom we have tax treaties?

Mr. GUNNER. Other than the one you have already mentioned in terms of the effect on the dollar, which is a big concern, there is also—we spoke with a competent authority for France, for example, and he told us that if the United States were to remove the 30-percent withholding tax that France would definitely have to follow suit and give consideration to removing its own withholding tax.

So ultimately we would be forcing the hand of some foreign countries. In order to remain at least somewhat competitive with the United States in terms of attracting money, they would have to take some follow-on actions.

Mr. GUARINI. So it will have a domino effect among our allies?

Mr. GUNNER. Very possibly, sir.

Mr. GUARINI. Thank you.

Mr. STARK [presiding]. Mr. Frenzel.

[No response.]

Mr. STARK. Mr. Pease.

[No response.]

Mr. STARK. No further questions. Thank you very much, Mr. Anderson.

Mr. ANDERSON. Thank you.

Mr. STARK. The next witness is the honorable and distinguished gentleman from Georgia, the Honorable Doug Barnard, who is chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs of the Committee on Government Operations, whose name has been mentioned many times this morning during these hearings.

Welcome to the committee, Congressman Barnard. It is indeed a pleasure to have a man of your caliber, expertise and knowledge to testify.

STATEMENT OF HON. DOUG BARNARD, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA, CHAIRMAN, SUBCOMMITTEE ON COMMERCE, CONSUMER, AND MONETARY AFFAIRS, COMMITTEE ON GOVERNMENT OPERATIONS, ACCOMPANIED BY PETER BARASH, SUBCOMMITTEE STAFF DIRECTOR; AND DEAN SCOTT, GENERAL ACCOUNTING OFFICE, ON ASSIGNMENT TO SUBCOMMITTEE

Mr. **Barnard**. Mr. Chairman, I am tempted to leave you at this point.

Mr. **Stark**. Your full statement will be made a part of the record, and you may proceed in any manner you desire.

Mr. **Barnard**. Thank you.

I appreciate very much this opportunity to appear before you and to discuss one of the many options that is before you today as far as the withholding of taxes on U.S. source income paid to foreign persons.

At the outset, Mr. Chairman, I would like to emphasize that I am certainly no tax expert. It is by inheritance that I acquired the chairmanship of the Subcommittee on Commerce, Consumer, and Monetary Affairs of Government Operations. This committee for a number of years has been looking into the issue of Eurobonds and their functioning through the Netherlands Antilles.

It is because of our oversight of the Treasury Department that we have noted that a renegotiated tax treaty has not been implemented with the Netherlands Antilles, and as a result, this problem of withholding has emerged from the standpoint of our oversight hearings.

I have with me two of my staff people this morning that I would like to present. One is Mr. Peter Barash, who is staff director of the subcommittee, and the other gentleman is Mr. Dean Scott, who is with the General Accounting Office that is on assignment to the Subcommittee on Commerce, Consumer, and Monetary Affairs.

There are several approaches to this withholding problem, about which you are very knowledgeable. The approach that I have taken in H.R. 4029 would immediately end witholding taxes to foreigners but only on U.S. corporate issue of Eurobonds, a specific type of debt instrument now issued through the Netherlands Antilles finance subsidiaries.

It would not permit the tax-free sale to foreigners of outstanding or future Treasury debt or domestically issued corporate debt, but it would authorize future targeted Eurobond debt issued by Fannie Mae, a congressionally chartered, but stockholder-owned corporation that finances the homebuilding industry.

So therefore I do appreciate this opportunity to discuss briefly this afternoon my bill, which is one of the three competing legislative approaches for resolving the withholding issue. Of these three, mine is far more in keeping with the essential purposes of the tax bill to raise, not lose revenue, and to close tax loopholes, not open new ones.

There are five essential reasons why I believe that H.R. 4029 is the most fiscally responsible and politically sound of the three approaches. No. 1, H.R. 4029 is a significant revenue preserver. The other two bills are significant revenue losers. We estimate that at a minimum H.R. 4029 will preserve at least $1.235 billion in tax revenues over the next 6 years, 1985 through 1990. The other two bills will lose at least $1.235 billion.

Even a slight shift of currently taxable public and private debt into tax-free debt sold to foreigners could increase this revenue loss by $1 billion a year for a 6-year total loss of $7.23 billion.

I want to acknowledge at this point the difficulty of producing firm numbers on the revenue consequences of the various bills, a difficulty faced by the Treasury Department as well, and I think even the figures that they have offered this morning, especially as it applies to the Senate bill, can be disputed to some degree.

Nevertheless, we are convinced that under Gibbons-Conable and Chafee-Bentsen there will be a significant net increase in foreign ownership of U.S. debt instruments that will produce profoundly negative tax consequences for the U.S. Treasury, and let me explain why.

In one category of tax revenues, recapture of tax credits representing U.S. corporate tax payments to the Netherlands Antilles Government, my bill and the other two bills will ultimately produce the same amount of revenues, and we estimate that to be $1.95 billion over the next 6 years.

However, in three other important tax categories, my bill will preserve significant revenues. The others will forfeit revenues as follows. H.R. 4029 will preserve for the U.S. Treasury $100 million a year in withholding taxes now collected from foreign persons on U.S. debt interest paid overseas. Because the two other bills make this interest tax-free, this $100 million in annual tax revenues will be lost.

My bill will preserve $525 million over 6 years representing potential new tax losses on U.S. corporate deductions from taxable income for their increased borrowing costs.

Under Gibbons-Conable and Chafee-Bentsen, U.S. corporate debt in the Eurodollar market—30 percent of total debt in 1982 and 1983—would be forced to compete with full faith and credit Treasury debt. This would inevitably result in significantly higher cost of corporate borrowing, a deductible business expense that will have to be shared by every American taxpayer.

My bill, because it avoids this public-private competition, will preserve this $525 million in revenue.

My bill will preserve an indeterminate but huge amount of tax revenues representing taxes now paid on that portion of outstanding public and private domestically issued debt that will be sold in secondary foreign capital markets under the two bills. There is presently $1.1 trillion in outstanding Treasury debt and $500 billion in corporate debt that would be eligible for tax-free resale in foreign capital markets under Gibbons-Conable and Chafee-Bentsen. Some of this huge pool of debt will be resold and will move therefore from a tax-producing to a non-tax-producing category.

For example, if you assume that only 5 percent of the outstanding taxable Treasury debt was resold in tax-free foreign capital markets, and if you assume further that the current taxable owners of this debt are only in the 20-percent tax bracket, the annual revenue loss to the U.S. Treasury would be $1.1 billion.

Since my sales and tax bracket hypothesis are conservative, the annual tax lost under Gibbons-Conable and Chafee-Bentsen could be far greater.

My second point is that H.R. 4029 will permit U.S. corporations to minimize their cost of credit in the Eurodollar market. The other two bills will result in significantly higher cost to U.S. corporations in the Eurodollar market. H.R. 4029 does not permit the U.S. Treasury to sell its debt in the Eurodollar market on a tax-free basis. The other two bills do.

Clearly if all Treasury debt, past, present, and future, is permitted to be sold overseas on a tax-free basis, it would create a competition with private corporate debt that would drive up the cost of that corporate debt in the Eurodollar market.

While competition between the public and private sectors is sometimes justified, this is not one of those instances.

I have already discussed the tax consequences of such competition, but it is also important to note that higher interest costs to U.S. corporations will mean ultimately higher prices to American consumers who purchase their products and services, and it will mean smaller profits to the millions of Americans who are the equity owners of these corporations.

Three, permitting Treasury debt to be sold in the Eurodollar market on a tax-free basis, permitted by the other two bills, will place increasing pressure on an already overvalued dollar against foreign currency. If Treasury debt is permitted to be sold tax free in the Eurodollar market, it would contribute to a strengthening of the dollar against foreign currencies at a time when an already overvalued dollar is helping to cause the greatest balance of trade deficit in our Nation's history, estimated at $110 billion this year.

Recently, Chairman Paul Volcker of the Federal Reserve warned, and I quote, "We simply can't afford to become addicted to drawing on increasing amounts of foreign saving to help finance our internal economy, because the stability of the dollar and other domestic financial markets could become hostage to events abroad."

Fourth, H.R. 4029 creates a withholding tax system consistent with that of other major industrialized nations. The other two bills do not.

Fifth, my bill does not jeopardize the tax compliance reforms of TEFRA and the backup withholding provisions of the Interest and Dividend Tax Compliance Act of 1983. The creation under Gibbons-Conable and Chafee-Bentsen of a pool of $1.1 trillion outstanding Treasury debt and $500 billion outstanding corporate debt that would be available for tax-free sale in secondary world capital markets, could create a significant tax compliance problem under TEFRA and backup withholding.

Because the provisions of TEFRA and backup withholding cannot be applied efficiently to sales in secondary markets, I am concerned that U.S. tax evaders will attempt to exploit this huge pool of outstanding debt. Because under my bill only new targeted Euroissues would be tax free, TEFRA and backup withholding procedures together with registration procedures utilized for such new targeted issues would minimize tax compliance problems.

I have already attempted to point out how the broad bill would have enormous negative tax consequences. I would like to remind the committee that it was these negative tax consequences that resulted in the overwhelming defeat of the broad bill, once in committee and once on the House floor. I believe it would be inappropriate and unfortunate for this Congress to approve a withholding tax repeal provision identical to those rejected previously.

For all of these reasons, Mr. Chairman, I am convinced that the House and Senate conferees should reject the sweeping approaches presented by Gibbons-Conable and Chafee-Bentsen in favor of H.R. 4029 which merely makes statutory what is presently taxable and nontaxable to foreigners under existing laws and tax treaties.

Permitting all Treasury debt and all other presently taxable debt to be sold tax free to foreigners sends an unfortunate signal to the American people, who are deeply concerned over $200 billion budget deficits and the fairness of our tax system. I respectfully urge the House conferees to adopt withholding tax provisions which will merely make current practices, statutory.

The narrow approach will preserve urgently needed tax revenues and maintain corporate access to the Eurodollar market.

Mr. Chairman, I appreciate very much this opportunity to present these arguments for our bill. Your consideration and the committee's is indeed solicited.

[The prepared statement follows:]

STATEMENT OF HON. DOUG BARNARD, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA, AND CHAIRMAN, SUBCOMMITTEE ON COMMERCE, CONSUMER, AND MONETARY AFFAIRS, COMMITTEE ON GOVERNMENT OPERATIONS

Mr. Chairman and members of the committee, I very much appreciate the opportunity to appear before this distinguished committee on the important issue of what Congress should do about withholding taxes on U.S. source interest income paid to foreign persons, particularly interest on Eurobonds. This matter has been pending far too long in Congress and it's my hope that the upcoming House-Senate Tax Conference will finally resolve the issue and in a way most in keeping with our broad national interests.

As the committee knows, there are three competing legislative approaches toward the withholding tax problem: Two of those approaches would eliminate the 30% withholding tax to foreigners on all outstanding and future public and private U.S. source debt instruments, whether issued domestically or overseas. Chafee/Bentsen, which is now a part of the Senate tax bill, would eliminate the withholding tax over a 4-year period. The legislation sponsored by our distinguished colleagues, Sam Gibbons and Barber Conable, would do so immediately upon enactment. The third approach is my bill H.R. 4029 which would immediately end withholding taxes to foreigners but only on future issues of U.S. corporate Europbonds, a specific type of debt instrument now issued through Netherlands Antilles finance subsidiaries. It would not permit the tax-free sale to foreigners of outstanding or future Treasury debt but it would authorize non-"full faith and credit" agency debt, much as that issued by Fannie Mae.

I come before this committee to respectfully urge that the House conferees adopt the provisions of my Eurobond legislation, H.R. 4029. The conferees should do so because of the three competing legislative approaches for resolving the withholding issue, mine is far more in keeping with the essential purpose of the tax bills: to raise, not lose revenues; and to close tax loopholes not open new ones. It would be ironic indeed if the Congress approved a withholding tax provision that mocked the overall tax bill's characterization as a "revenue enhancer" and "tax loophole closer".

There are five essential reasons why I believe that H.R. 4029 is the most fiscally responsible and politically sound of the three approaches:

(1) *H.R. 4029 is a significant revenue preserver; the other two bills are significant revenue losers:* We estimate that at a minimum H.R. 4029 will preserve at least

$1.235 billion in tax revenues over the next 6 years, 1985 through 1990. The other two bills will lose at least $1.235 billion. Even a slight shift of currently taxable public and private debt into tax-free debt sold to foreigners (permitted under Gibbons/Conable and Chafee/Bentsen) could increase this revenue loss by $1 billion dollars a year, for a 6-year total loss of $7.235 billion.

I want to acknowledge at this point the difficulty of producing firm numbers on the revenue consequences of the various bills, a difficulty faced by the Treasury Department as well. Nevertheless, we are convinced that under Gibbons/Conable and Chafee/Bentsen there will be a significant net increase in foreign ownership of U.S. debt instruments that will produce profoundly negative tax consequences for the U.S. Treasury. Let me explain why:

In one category of tax revenues—recapture of tax credits representing U.S. corporate tax payments to the Netherlands Antilles Government—my bill and the other two bills will ultimately produce the same amoung of revenues. We estimate $1.95 billion over 6 years. However, in three other important tax categories my bill will preserve significant revenues, the others will forfeit those revenues, as follows:

(a) My bill will preserve for the U.S. Treasury $100 million a year in withholding taxes now collected from foreign persons on U.S. debt instrument interest paid overseas. Because the other two bills make this interest tax free, this $100 million in annual tax revenues will be lost.

(b) My bill will preserve $525 million over 6 years representing potential new tax losses on U.S. corporate deductions from taxable income, for their increased borrowing costs. Under Gibbons/Conable and Chafee/Bentsen, U.S. corporate debt in the Eurodollar market (30% of total debt in 1982 and 1983) would be forced to compete with "full faith and credit" Treasury debt. This would inevitably result in significantly higher costs of corporate borrowing—a deductible business expense that will have to be shared by every American taxpayer. My bill, because it avoids this public-private competition, will preserve this $525 million in revenue. The other bills will cause it to be lost.

(c) My bill will preserve an indeterminate but huge amount of tax revenues representing taxes now paid on that portion of outstanding public and private domestically issued debt that will be sold in secondary foreign capital markets under the other two bills. There is presently $1.1 trillion in outstanding Treasury debt and $500 billion in corporate debt that would be eligible for tax-free resale in foreign capital markets under Gibbons/Conable and Chafee/Bentsen. Some of this huge pool of debt will be resold and will more, therefore, from a tax-producing to a nontax-producing category.

For example, if you assume that only 5% of the outstanding taxable Treasury debt was resold in tax-free foreign capital markets and, if you assume further that the current taxable owners of this debt are only in the 20% tax bracket, the annual revenue loss to the U.S. Treasury would be $1.1 billion. Since my sales and tax bracket hypotheses are conservative, the annual tax loss under Gibbons/Conable and Chafee/Bentsen could be far greater

(2) *H.R. 4029 will permit U.S. corporations to minimize their costs of credit in the eurodollar market; the other two bills will result in significantly higher interest costs to U.S. corporations in the Eurodollar market:* H.R. 4029 does not permit the U.S. Treasury to sell its debt in the Eurodollar market on a tax-free basis. The other two bills do. Clearly, if all Treasury debt—past, present and future—is permitted to be sold overseas on a tax-free basis, it would create a competition with private corporate debt that would drive up the cost of that corporate debt in the Eurodollar market. While competition between the public and private sector is sometimes justified, this is not one of those instances. I have already discussed the tax consequences of such a competition. But it is also important to note that higher interest costs to U.S. corporations will mean, ultimately, higher prices to American consumers who purchase their products and services. And it will mean smaller profits to the millions of Americans who are the equity owners of those corporations.

(3) *Permitting Treasury debt to be sold in the Eurodollar market on a tax-free basis—permitted by the other two bills—will place increasing pressure on an already overvalued dollar against foreign currencies:* If Treasury debt is permitted to be sold tax free in the Eurodollar market it would contribute to a strengthening of the dollar against foreign currencies at a time when an already overvalued dollar is helping to cause the greatest balance of trade deficit in our Nation's history—estimated at $110 billion this year. Recently, Chairman Volcker of the Federal Reserve warned:

"We simply can't afford to become addicted to drawing on increasing amounts of foreign savings to help finance our internal economy because the stability of the dollar and our domestic financial markets would become hostage to events abroad."

(4) *H.R. 4029 creates a withholding tax system consistent with that of other major industrialized nations; the other two bills do not:* Virtually no major industrialized nation in the world allows the kind of unimpeded, tax-free access to its domestic securities market that Gibbons/Conable and Chafee/Bentsen would permit. My Eurobond legislation, on the other hand, would be consistent with international financing structures existing in most major industrialized nations such as Germany and the United Kingdom. These nations, as well as Japan, allow specified borrowers to access international capital markets free of local withholding tax but do not allow as would the other two bills—domestically issued government and corporate securities to be owned tax free by nonresidents.

(5) *My bill does not jeopardize the tax compliance reforms of TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) and the backup withholding provisions of the Interest and Dividend Tax Compliance Act of 1983; the other two bills might do so:* The creation, under Gibbons/Conable and Chafee/Bentsen, of a pool of $1.1 trillion outstanding Treasury debt and $500 billion outstanding corporate debt, that would be available for tax-free sale in secondary world capital markets, could create significant tax compliance problems under TEFRA and backup withholding. Because the provisions of TEFRA and backup withholding cannot be applied efficiently to sales in secondary markets, I am concerned that U.S. tax evaders will attempt to exploit this huge pool of outstanding debt. Because under my bill, only new, targeted Eurobond issues would be tax free, TEFRA and backup withholding procedures, together with registration procedures utilized for such new targeted issues, would minimize tax compliance problems.

I have already attempted to point out how the broad bill would have enormous negative tax consequences. I would like to remind the committee that it was these negative tax consequences that resulted in the overwhelming defeat of the broad bill—once in committee and once on the House floor—in prior Congresses. I believe it would be inappropriate and unfortunate for this Congress to approve a withholding tax repeal provision identical to those rejected previously.

For all of these reasons, Mr. Chairman, I am convinced that the House and Senate conferees should reject the sweeping approach represented by Gibbons/Conable and Chafee/Bentsen in favor of H.R. 4029 which merely makes statutory what is presently taxable and nontaxable to foreigners under existing laws and tax treaties. Permitting all Treasury debt and all other presently taxable debt to be sold tax free to foreigners sends an unfortunate signal to the American people who are deeply concerned over $200 billion budget deficits and the fairness of our tax system. I respectfully urge the House conferees to adopt withholding tax provisions which will merely make current practice statutory. This narrow approach will preserve urgently needed tax revenues and maintain corporate access to the Eurodollar market.

Mr. STARK. Thank you very much, Congressman Barnard.

Let me quote to you from the March 3, 1984, issue of The Economist, an issue I am sure you are familiar with, but in the concluding paragraphs of an article dealing with—saying that it is good that we may scrap our withholding tax on foreign investors, but they say better we do it slowly. The concluding paragraphs say the second proposal from Georgia Democrat Mr. Doug Barnard is to abolish withholding tax only on the Eurobond issues of American companies so as to plug the Antilles tax drain.

Foreigners subscribing to domestic issues would still pay the 30-percent withholding tax. I am paraphrasing a little bit here. This would keep the United States in step with Europe. France already allows companies to pay interest gross on Eurobonds, and Britain will follow suit in the budget on March 13. That gradual dismantling of withholding taxes makes sense for other reasons.

Now is the wrong time to help America's Federal Government entrench its budget deficit by making it easier to tap new lenders, and as nobody has suggested similar concessions for dividends, the Gibbons-Conable bill would lead to a rise in the debt-equity ratios of American companies just when a fall, or the reverse, I think they mean, is needed.

Do you want to comment on those paragraphs?

Mr. **Barnard**. Well, essentially, I think that The Economist is supporting the proposition that now is no time to plug up the withholding provision at a great cost to the Treasury, and I think that this is a consideration that is overwhelming when you consider today the direction that we are trying to go on these particular problems.

Of course, the problem has been with us many years. I think we are coming closer now to correcting it than before. But I think—I hope that we will not overcorrect it to the degree that we are going to be sacrificing some very much needed revenues in the meantime.

I don't fault the fact that at some period of time we might go to across-the-board elimination of withholding, but as far as this time and this place, I believe that we are only really in a position to do that with Eurobond issues at this time.

Mr. **Stark**. Would you suggest that in fact there would be no real problem if the only bonds we allowed to be issued were registered bonds? As long as we get out of the bearer bond business, there is really no need for withholding, is there?

Mr. **Barnard**. I am advised that while we would not have the compliance problem, we would still have the revenue losses.

Mr. **Stark**. Because people wouldn't buy the bonds?

Mr. **Barnard**. Yes.

Mr. **Stark**. Is that the reason?

Mr. **Barnard**. Well, we feel like in that instance, Mr. Chairman, the market would be very, very selective as to what they would buy and what they would not buy.

Mr. **Stark**. That is what I gathered that you meant. You have urged this narrow exemption from the withholding tax which would help corporate borrowers obviously, but do you see——

Mr. **Barnard**. And small businesses, Mr. Chairman.

Mr. **Stark**. Do you see compliance problems with issuing more bearer bonds? We have seen in this committee repeated abuses both of municipal bonds, which is the biggest domestic example, and we have tried to preclude any new issues of—certainly domestically of bearer bonds, just because it becomes a vehicle for the underworld and not for responsible business people. There is no really good reason to issue bearer bonds in the United States any more except for tax avoidance.

Now, do you think once you begin to get domestic issues in bearer form out and abroad that we would create any additional compliance problems?

Mr. **Barnard**. Mr. Chairman, our legislation would be directed to——

Mr. **Barash**. Targeted Eurobond issues. It would not permit domestically issued——

Mr. **Stark**. Do you think there would be adequate safeguards to keep those from getting back to the domestic world.

Mr. **Barash**. That is correct.

Mr. **Stark**. Mr. Gibbons.

Mr. Jenkins.

Mr. **Jenkins**. Thank you, Mr. Chairman.

I want to thank my colleague from Georgia for bringing this version of proposed legislation to the committee. I think you are on the right track. As I understand your proposal, basically what you would do is to simply codify what is happening as a practical matter now. Therefore, as you indicate in your testimony, U.S. corporations are, because of existing law, simply setting up offices in the Netherlands to accomplish what you want to accomplish directly. Is that correct?

Mr. **Barnard**. Because of the present structure of the tax treaty, we are losing this very significant revenue every year. We are just codifying by statute what is presently authorized, nothing more and nothing less.

Mr. **Jenkins**. But you are fearful of going beyond this point and expanding it as the Conable-Gibbons or the Chafee approach to open it up to U.S. obligations directly.

Mr. **Barnard**. Actually, I do not think we need to do that at this particular time. I think that in all equity, we ought to codify for all Eurobond issues what is being done as far as withholding, but as far as bringing under that umbrella further corporate debt or further public debt, I think it is a step beyond where we need to go at this time with our deficits being what they are, and the revenue losses that is going to be to the Treasury.

Mr. **Jenkins**. And your bill will raise how much in revenue over the next 3 years?

Mr. **Barnard**. From the best figures we can get from the Treasury, the next 5 years, we would bring in about $1.235 billion at a minimum.

Mr. **Jenkins**. Mr. Barnard, I want to thank you on behalf of the committee and myself for bringing this matter to our attention. I think your approach is a very wise approach, and I appreciate your leadership in that field.

Mr. **Barnard**. Thank you.

Mr. **Stark**. Mr. Gibbons.

Mr. **Gibbons**. Mr. Barnard, first of all, as you know, I am a cosponsor of your bill, too.

Mr. **Barnard**. That is what is giving me encouragement.

Mr. **Gibbons**. I think we have done a stupid thing by making it very difficult for Americans to get hold of capital, and I want to make sure that Americans are not discriminated against in getting hold of capital. I have gotten a written letter from Treasury, from Mr. Chapoton, and I want to read the last sentence of it.

It says, "The net revenue gained from such amendment," talking about mine, "to the Internal Revenue Code would be on a conservative basis $35 million and could well be as much as $50 million." He is talking about per year. He is talking about my bill. Now, have you been able to get out of Mr. Chapoton anything in writing on our bill, your bill and my bill?

Mr. **Barnard**. I did not get that question, Mr. Chairman.

Mr. **Gibbons**. Have you been able to get anything out of Mr. Chapoton on your bill and my bill in writing about his revenue estimates on your bill?

Mr. **Barnard**. Mr. Gibbons, we have found it very difficult to get any hard figures, and the fact is, as of this morning at 9 o'clock we got a telephone call from which we got some figures which we certainly do not agree to, and we really feel like the Treasury needs to go back to the drawing board.

Mr. GIBBONS. Thank you.

Mr. STARK. Mr. Frenzel.

Mr. FRENZEL. Doug, we appreciate the work you have done in this very complicated field, in which it is very tough for us to make a decision. Your bill, as I understand it, kills withholding except for the Federal Government.

Mr. BARNARD. No; it excludes the Federal Government. In other words, the withholding exemption would apply only to new issues of corporate Eurobonds, but would include the Fannie Mae bonds.

Mr. FRENZEL. Thank you. I think you have done some awfully good work in the field. It is a question of what is to be included and what is to be excluded. I assume that in making your proposal, you are looking to give us better access to worldwide credit markets?

Mr. BARNARD. Well, at least as far as the Eurodollar market is concerned. We feel like it would make easier and quicker access, and we would certainly be treating everyone alike. You know, those who set up corporations in the Netherlands Antilles will not get any greater benefits than other issues issued in any other parts of the world.

Mr. FRENZEL. As I indicated earlier, though, apparently the U.S. Treasury could not.

Mr. BARNARD. That is exactly right. You see, I would remind the distinguished gentleman from Minnesota that the Treasury under the other bills would be able to lump $1.1 trillion of their present outstandings into tax-free obligations, and you can see what that is going to do to the marketplace. It is going to freeze out corporate borrowers, and not only that. You can see the revenue losses taxwise and otherwise it would experience.

Mr. FRENZEL. But on the other hand your bill gives it an inferior status in the Eurobond market.

Mr. BARNARD. Yes; in actual figures, if we included the public debt in the withholding provision, you may be saving the Treasury something like—these quick figures are certainly debatable, but we are talking about you are saving the Treasury possibly something like one-eighteenth of 1 percent of the national debt. We will acknowledge that.

But on the other hand, you are going to be increasing tax revenue losses and you are going to be increasing the interest paid by corporations which will then pass it on over to the consumers, and I know there is an interest here about the small borrower. The small businessman will certainly be impacted under that situation.

We just think that the consequences of that small saving to the Treasury will be compounded otherwise.

Mr. FRENZEL. The small saver is also a taxpayer, is he not?

Mr. BARNARD. That is right.

Mr. FRENZEL. Well, it is a really good question. We are confronted here with the prospect of subsidizing foreign credit. Although I do not like that description, that is about what it is, and we are doing it for what we think is a useful purpose, and the credit is needed, but it is a real question.

I have been a supporter of your concept and one of the broader Gibbons concept. We ought to know what we are doing and be able to identify, insofar as possible, what some of the fallout is from what we are doing. Do you suggest, for instance, that it might be a good idea to limit the duration of this repeal, rather, to make it a deferral for a few years?

Mr. Barnard. We have considered that, sir, but we feel like that would not be—that the uncertainty there would not benefit the corporations going to the Eurodollar market.

Mr. Frenzel. Again, Doug, we really appreciate the hard work you have done in this field, and we value your counsel.

Mr. Stark. Mr. Gephardt.

Mr. Gephardt. Thank you, Mr. Chairman.

I echo the comments of those who have complimented you on what you have done. I appreciate your testimony, and think that your approach is a better approach than is represented by either the Senate approach or the bill that is before us here. And I want to focus directly on what to me is the most worrisome part of simply changing the policy quickly or at all with regard to the way we withhold on U.S. securities.

In your testimony, at page 4, you quote Chairman Volcker where he said we simply cannot afford to become addicted to drawing on increasing amounts of foreign savings to help finance our internal economy, because "the stability of the dollar and our domestic financial markets would become hostage to events abroad."

I take it he said that before your committee, or to some other committee of the Congress.

Mr. Barnard. He made the statement before the House Banking Committee.

Mr. Gephardt. I think it relates directly to what we are talking about, and gives me great pause to want to just take withholding off of U.S. securities. Second, we have before us today here testimony by William Anderson. But he is with the U.S. General Accounting Office.

In examining both bills, the Senate approach and the phaseout approach that is here, he says that a second and perhaps more important difference between the two bills is that H.R. 2363 would also have the effect of opening up U.S. capital markets by removing withholding tax on registered securities as well as Eurobonds.

He says this could have far-reaching and as yet unpredictable effects on the international capital markets. Then he goes on to say that tax authorities from France told us that if the United States were to eliminate its 30-percent withholding tax on interest, they would have to consider eliminating their tax as well.

It seems to me that if we do this, even in a phased way, we are going to encourage European countries to protect themselves. They are going to have to protect their capital. They cannot have that much capital flowing here to U.S. securities.

I would like your comment on both those statements.

Mr. Barnard. Well, that is one aspect of H.R. 4029, Mr. Gephardt, and that is that we would be paralleling what other major countries are doing today, not doing more, as far as withholding is concerned. And you are right. If we open it up to public debt and others, they would have to come back, and if they saw that much of a flow back into the American market, they would have to retaliate in some degree.

Mr. **Gephardt**. I just think it is a poor time to be running an experiment with the international capital markets. I do not think we know the consequences. I think we can solve the tax problem we have here with your approach and not go further, and I think that is the way to do it.

I appreciate your testimony.

Mr. **Barnard**. Thank you very much.

Mr. **Stark**. Mr. Guarini.

Mr. **Guarini**. Thank you, Doug, for the benefit of your testimony. Certainly what you say would help to close loopholes. It is a more conservative approach. Probably it would help to eliminate some laundering of illegal dollars and at the same time give us a little less dependency on foreign markets, so there is more sensibility, I think, to the approach that you have taken.

What would you do in regard to the tax treaties that we have with these different countries? How would you treat that situation? Just leave it as it is?

Mr. **Barnard**. We feel like the Treasury, from our oversight and from our hearings, the Treasury has indeed been very dilatory in trying to effectuate a new tax treaty with the Netherlands Antilles, and we really feel like they ought to get on with it. We are very sympathetic with the Netherlands Antilles as far as this problem is concerned, but it has been with us a long time, and now is the time for us to really resolve it, but there are other aspects of this tax treaty that we feel can benefit the Netherlands Antilles, and we are hoping that it can very quickly reach some solution.

Mr. **Guarini**. We have gone a long way to try to do something there with CBI, and that is only this past year, and now suddenly we take a step in the opposite direction and pull some of the economy out from under them, and I am just wondering whether or not there is something more that we should do to balance this off.

Mr. **Barnard**. Let me say, speaking as one Member of Congress, I certainly do support a strong relationship with the Netherlands Antilles. I do not know what the answer to that is, but I certainly do not think it should be through the significant tax loophole. I mean, I think there is too much to lose with this particular feature of it.

But I certainly would think that we as a government should respect the friendship of the Netherlands Antilles, and should work with them through the Caribbean Basin Initiative as well as some other areas to be helpful to them, especially as they withstand this economic loss that they are going to be going through with.

Mr. **Guarini**. I agree that we should show some very grave concern, and should address ourselves to that.

Mr. **Barnard**. I would like to be strongly on record in some sympathetic action with them.

Mr. **Guarini**. More than sympathy.

Mr. **Barnard**. Yes; financial, too.

Mr. **Guarini**. Let me ask you, as I understand your bill it only refers to registered bonds, or does it refer to bearer bonds, too?

Mr. **Barnard**. Right.

Mr. **Guarini**. If it only refers to registered bonds, how do you get away from the problem of avoiding what you want to achieve? People would just turn to bearer bonds, and they have eliminated your loophole closing. Can people circumvent by buying bearer bonds?

Mr. **Scott.** Presently, Mr. Barnard's bill, of course, only allows targeted issues of Eurobonds issued by U.S. corporations. Now, it is our understanding, and based on my conversations with persons who are very familiar with how that particular market works, which is primarily based in London and Brussels, they do have safeguards over there, and they have regulations, and in fact in some cases even laws similar to our own Securities and Exchange Commission in this country which require certain specified kinds of actions like a 90-day lockup whereby sales can only be to certain directed agents.

Eurobond interest can only be paid by certain designated paying agents. Those paying agents are required to keep a record at least of the nominee account or whatever that the interest is being paid to. It is Mr. Barnard's view and our view that Eurobonds do not lend themselves to the kind of tax compliance problem we see whereas if you just make tax free any bonds issued from this country, there is no control over those. We do see a major tax compliance problem there because there are no controls.

Mr. **Guarini.** But there is always ingenuity in the marketplace, particularly when you are dealing with money, and if you do not sunset a bill, I am just wondering whether or not the addition of bearer and registered would be there even though you would have more difficult compliance. Still, the prohibition of dealing on any level, whether it is registered or bearer, would be a violation of the law, and so I would say should not bearer be added so that you generically cover the whole subject matter?

Mr. **Barash.** Of course, under the Barnard bill, TEFRA would apply, and the registration provisions normally applied to Eurobond issues, targeted issues, would also apply. Whatever the tax compliance problems there may be under Barnard, they would be significantly less than under the present arrangements or the broader bills.

Mr. **Guarini.** But I am only pointing out what would be the disadvantage of saying all bonds. Why just restrict it to registered bonds if you are trying to achieve an end result? Just say all bonds, and if someone does deal in bearer bonds, it is an obvious violation. They would have the fear of being caught and at least the prohibition would be there.

Mr. **Barnard.** I think—I certainly think that that is a thought that ought to be pursued. I really have not given it that much thought.

Mr. **Guarini.** Would you perhaps give us the benefit of your thoughts or that of your staff if you do look into it?

Mr. **Barnard.** We would be glad to.

Mr. **Guarini.** Thank you very much, Doug.

Mr. **Jenkins** [presiding]. Are there further questions of Mr. Barnard?

Mr. Barnard, we thank you for your appearance before the committee.

Our next panel, Mr. Won Pat, together with Governor Bordallo and Mr. Gutierrez. We are delighted to have our colleague, Mr.

Won Pat, before the committee today, and he will introduce the panel that is accompanying him.

STATEMENT OF HON. ANTONIO BORJA WON PAT, A DELEGATE IN CONGRESS FROM THE TERRITORY OF GUAM

Mr. Won Pat. Thank you, Mr. Chairman, and distinguished members of the Committee on Ways and Means.

With me on my left is the Governor of Guam, Ricardo Bordallo, and on my right is the Speaker of the Guam Legislature, Carl Gutierrez.

Mr. Jenkins. Governor, we are delighted to have you and Mr. Gutierrez. We are delighted to have you with us today.

Mr. Won Pat. On my extreme left is the legal counsel to the Governor.

Mr. Chairman and distinguished members, thank you for the opportunity to testify and to present my Governor and legislature speaker. I am not going to comment on the wisdom of the bills before you today. I simply want to make sure that you understand the unique implications they have for my territory, and ask that they be appropriately acted upon if the provisions of these bills are considered in the conference on the tax bill.

In 1972, I lobbied Congress to exempt Guam from the 30-percent withholding tax which was applied to the territory under the so-called mirror system of taxation. The intent of what became section 881(b) of the Internal Revenue Code was to accomplish the Federal and territorial goal of stimulating investment in the island.

When substantial interest in the provision developed in 1982, the IRS sought to prevent use of it through an illegitimate regulation. This excessive grab of regulatory authority galvanized opposition in Guam. Yet, from the beginning, my territory willingly recognized that the abuses of tax treaty nations should not be repeated in its case.

Still, preoccupied with the Netherlands Antilles negotiations, Treasury put Guam off.

First, it told the territory that it would resolve the dispute when the negotiations with the Netherlands Antilles were finalized. Despite this, Treasury was unwilling to let Guam exercise the exemption until agreement was reached with the Antilles, although the territory said it was willing to have the exemption curtailed to whatever was agreed to with those foreign islands.

Then, when the Antilles treaty was extended, Treasury said it wanted to see whether Congress would remove the 30-percent withholding tax altogether before resolving the dispute.

Frustrated, Guam filed suit to preserve section 881(b), as written in law. Treasury responded by persuading you to include significant restrictions of it in the tax bill.

The bills before you today would, of course, obviate the advantage of Guam's exemption. By phasing out the withholding tax, the Senate version of the tax bill would substantially reduce the advantage, at the least.

But, if you decide that either of the bills before you today or the Senate version of the tax bill on this issue should be enacted, I believe that you will want to drop section 137 of the House-passed bill in conference.

It makes no sense to restrict Guam's exemption if the tax the exemption is from is done away with immediately or over time, or if Eurobonds are also exempted from the 30-percent tax.

It would make sense, however, to provide no less favorable treatment to Guam and other territories in the event of an agreement with the Netherlands Antilles if the phasing out is agreed to by the conference. This would accomplish Guam's goal of having U.S. territories treated equitably with tax treaty nations. Such an advantage might not be great or even significant, but it would be a clear and reassuring statement that U.S. islands will not be disadvantaged vis-a-vis foreign islands when Federal tax policy is made.

The staff of the Subcommittee on Insular Affairs, which I chair, is willing to work with yours on these suggestions if you so agree.

Now, Mr. Chairman and members, it is my pleasure to introduce Governor Bordallo, who will address this issue more comprehensively, since he has been vigorously pursuing this issue, and he will be followed by the testimony of the speaker of the Guam Legislature, Carl Gutierrez, on my right.

Thank you, Mr. Chairman.

Mr. JENKINS. Thank you, Mr. Won Pat.

Governor, we would be delighted to hear from you.

STATEMENT OF HON. RICARDO J. BORDALLO, GOVERNOR, TERRITORY OF GUAM

Governor BORDALLO. Mr. Chairman and esteemed members of this august Committee on Ways and Means, as introduced, I am Ricardo J. Bordallo, Governor of Guam, Territory of the United States.

The people of Guam join me in expressing our sincere appreciation for providing us the opportunity of publicly stating our position on the topic of this hearing, the tax treatment of interest paid to foreign persons.

This committee's press release No. 20 announced the hearing will focus on these, H.R. 3025 and H.R. 4029, legislative proposals, and other alternatives to the 30-percent tax which may assist domestic borrowing needs without damaging other aspects of the U.S. economy or increasing tax noncompliance.

I am here to testify on how, under current law, the needs of domestic borrowers may be met without damaging the U.S. economy. The answer is simple. Use the Territory of Guam as the jurisdiction to form international finance subsidiaries. Tax havens could be eliminated if the U.S. companies did their foreign borrowing through Guam, since the income tax laws in force in the United States are likewise in force in Guam.

The possibilities for tax avoidance and evasion do not exist in Guam. As the Governor of the U.S. Territory of Guam, I am here to express the dismay and frustration of the people of Guam, all of whom are born American citizens, at this Treasury action. The American citizens on Guam want to know why Treasury allows the Netherlands Antilles treaty to continue while with its other hand it summarily decrees that section 881(b) of the Internal Revenue

Code does not authorize Guam to establish and engage in Eurobond financing.

The American citizens on Guam want to know why the U.S. Congress would schedule many hearings to listen to the litany of abuses that occur daily in the foreign islands in the Caribbean when without the benefit of a hearing this committee would insert section 137 into H.R. 4170 amending section 881(b) to repeal Guam's authorization to develop as a financial center, and mooting an ongoing court suit to determine the extent of our authority.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory where the Internal Revenue Code is fully applicable. All interest and dividend payments made by every bank and corporation on Guam would therefore be mandatorily reported to the Department of Revenue and Taxation, and therefore directly available to the Internal Revenue Service.

All investments and interest received and paid by corporations in Guam would be fully reported. All investments, interest, and dividends received by individuals would be fully reported. None of the congressional committees have studied how much tax revenue is lost by the nonreporting of individual interest and dividends received by individuals through Caribbean tax havens.

This loophole would not exist on Guam. Guam is the best alternative site for Eurobond financing because it is a U.S. territory that is subject to regulations under the U.S. banking laws. Secret bank accounts therefore do not exist. Laundering of money from drugs and other illegal sources can easily be detected by bank examiners of the Guam Department of Revenue and Taxation as well as FDIC, FSLC, and other Federal banking authorities.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory where all the laws safeguarding against the abuses occurring in the Caribbean are fully enforceable.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory where the U.S. District Court of Guam has the congressionally mandated jurisdiction over the enforcement of the Internal Revenue Code and its mirrored territorial income tax.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory where the Department of Justice and the Federal Bureau of Investigation have full jurisdiction to investigate and prosecute any violations of all U.S. laws applicable to Guam.

Guam is the best alternative site for Eurobond financing because it is the U.S. territory located closest to Asia, and especially Hong Kong, which makes it a convenient relocation site for all activities in the Netherlands Antilles as well as the investment opportunities that are leaving Hong Kong in anticipation of the return to Chinese rule in 1997.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory. Therefore, all investments made on Guam would not contribute to our country's ever-growing trade deficit, and would therefore improve the overall picture of the U.S. balance of trade.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory heavily dependent on Federal grants, and a reduction in said dependence would alleviate the burden of the

U.S. Treasury, thereby contributing to a reduction in our country's ever-growing national deficit.

Mr. Chairman, if this committee is indeed sincere about focusing on other alternatives which may assist domestic borrowing needs without damaging other aspects of the U.S. economy or increasing tax noncompliance, then Guam is the answer.

Mr. Chairman, I have taken the liberty of appending to my statement a brief prepared by my counsel in our suit against the U.S. Treasury regarding our section 881(b) authority. I have also taken the liberty of appending a page from the National Governors' Association policy positions for 1983–84, which includes a resolution on international finance subsidiaries passed by the National Governors' Association at its summer meeting in Maine last August 1983.

The resolution reads as follows:

> The National Governors Association recommends that the United States government encourage the establishment of international finance subsidiaries in U.S. territories where such is authorized by statute before it consummates any tax treaties with foreign jurisdictions to do the same.

In conclusion, I do not question the validity or the wisdom of the existence of the 30-percent withholding tax. I do, however, strongly question the fundamental fairness of allowing foreign entities to be the site for international finance subsidiaries while preventing Guam, an American territory, from engaging in the same activity.

Thank you.

[The prepared statement follows:]

STATEMENT OF HON. RICARDO J. BORDALLO, GOVERNOR OF GUAM

Mr. Chairman and esteemed members of this august Committee on Ways and Means.

I am Ricardo J. Bordallo, the Governor of Guam, a Territory of the United States.

The people of Guam join me in expressing our sincere appreciation for providing us the opportunity to publicly state our position on the topic of this hearing, the "tax treatment of interest paid to foreign persons."

This committee's press release #20 announced "the hearings will focus on these (HR 3025 and HR 4029) legislative proposals and other alternatives to the 30-percent tax which may assist domestic borrowing needs without damaging other aspects of the U.S. economy or increasing tax noncompliance."

I am here to testify on how under current law the needs of domestic borrowers may be met without damaging the U.S. economy. The answer is simple—use the Territory of Guam as the jurisdiction to form international finance subsidiaries. This would permit termination of the U.S.-Netherlands Antilles income tax treaty, a major source of tax non-compliance.

Over the last several years and especially during this last year, various committees of this House of Representatives and the U.S. Senate have conducted numerous hearings on tax haven issues and more specifically how to curb the abuses of laundering drug monies, and secret bank deposits and investments in the Carribbean. At the behest of Congressmen and Senators, tax treaties of several island countries were terminated unilaterally.

The initial versions of the Caribbean Basin Initiative limited the participation to island nations that entered into agreements with the U.S. Treasury Department to provide access and information. For some supposedly "national security" reasons this prerequisite was deleted and baltant abusers such as the Netherlands Antilles, the Caymen Islands and others are now beneficiaries of the Carribbean Basin Initiative. Despite its public statements, even the U.S. Treasury Department refused to summarily terminate the Netherlands Antilles treaty last year. Unless the Treasury acts by June 30th, the Antilles treaty will be again extended, this time until the beginning of 1986.

Tax havens, particularly the Netherlands Antilles, could be eliminated if U.S. companies did their foreign borrowing through Guam. Since the income tax laws in force in the United States are likewise in force in Guam, 48 U.S.C. 142li; the possibilities for tax avoidance and evasion existing in the Antilles do not exist in Guam.

For this reason we would have expected the Treasury and the Congress to encourage the development of Guam while phasing out the Antilles treaty. In fact, just the opposite occurred.

As the Governor of the U.S. Territory of Guam, I am here to express the dismay and frustration of the people of Guam, all of whom are born American citizens, at this Treasury action.

The American citizens on Guam want to know why Treasury allows the Netherlands Antilles treaty to continue while with its other hand it summarily decrees that Section 881(b) of the Internal Revenue Code does not authorize Guam to establish and engage in Eurobond financing.

The American citizens on Guam want to know why the U.S. Congress would schedule many hearings to listen to the litany of abuses that occur daily in the foreign islands in the Carribbean, when without the decency of the benefit of a hearing this committee would insert Section 137 into HR 4170, amending Section 881(b) to repeal Guam's authorization to develop as a financial center and mooting an ongoing court suit to determine the extent of our authority.

To understand the concern of the American citizens on Guam it is necessary to review the development of the Guam territorial income tax.

As part of the Organic Act of Guam, passed by the U.S. Congress in 1950, the Internal Revenue Code is made applicable as a "territorial income tax." (48 U.S.C. § 142li). This is accomplished by what has become commonly known as "mirroring". (48 U.S.C. § 142li(e)).

As a result, the Guam territorial income tax, although based on the Internal Revenue Code ("IRC"), is a taxation system separate and distinct from the U.S. taxation system. *Laguana* v. *Ansell*, 102 F.Supp. 919 (D.C. Guam, 1952), aff'd, 212 F.2d 207 (9th Cir. 1954), cert. denied, 348 U.S. 830 (1954); *Wilson* v. *Kennedy*, 123 F.Supp. 156 (D.C. Guam, 1954), aff'd, 232 F.2d 153 (9th Cir. 1956); S. Rep. No. 2176, 85th Cong., 2nd Sess., reprinted in 1958 U.S. Code Cong. & Ad. News 3647; *Jennings* v. *United States*, 168 F.Supp. 781, 784 (Ct. Cl. 1958); *Sayre & Company* v. *Riddell*, 395 F.2d 107, 410 (9th Cir. 1968) ("[S]ection 31 [of the Organic Act] established a territorial income tax to be collected by the Government of Guam, and that Guam and the United States were to be treated as separate and distinct taxing jurisdictions even though their income tax laws arose from an identical statute applicable to each."); 48 U.S.C. § 1421i(b). Under the Organic Act of Guam, the Governor of Guam is given the overall responsibility for administration and enforcement of the Guam territorial income tax—including the authority to issue all "needful rules and regulations." (48 U.S.C. § 1421i (c) and (d)(2)).

Contrary to the assertions of the Department of the Treasury the Guam situation is different from that of the Virgin Islands inasmuch as Congress has not seen fit to confer the authority to issue rules and regulations on the Governor of the Virgin Islands. *See*, Revised Virgin Islands Organic Act, 48 U.S.C. § 1451.

Under §§ 881(a) and 1442 of the IRC, U.S. source interest and dividends paid by a U.S. company to foreigners are subject to a 30% withholding tax, unless the rate is reduced or eliminated by a tax treaty or otherwise. Since Guam and the United States are considered "foreign" to one another for income tax purposes, the same rule previously applied to Guam-United States transactions. Thus, prior to the enactment of 26 U.S.C. § 881(b) in 1972, if a Guam corporation borrowed money from a U.S. corporation, it was required to withhold 30% of the interest payments to the U.S. corporation as tax. *Sayre & Company, Ltd.* v. *Riddell, supra*, overruling *Atkins-Kroll (Guam) Ltd.* v. *Government of Guam*, 367 F.2d 127 (9th Cir. 1966).

Because this result was deemed too harsh and seen as discouraging investment in Guam, Congress enacted 26 U.S.C. § 881(b). Section 881(b) provides that, for the purposes of the withholding obligation of § 881(a), a Guam corporation shall not be deemed a foreign corporation. Through mirroring, the same rule applies to interest paid to a Guam corporation by a U.S. corporation.

In essence, by eliminating the withholding tax, § 881(b) functions much the same way that a tax treaty does. (*See, Sayre & Company, supra*, 395 F.2d at 413 which states "Congress has provided an avenue of relief from combined tax burdens imposed upon dividend income paid to foreign parent corporations through the medium of the treaty-making power. Congress could as readily provide relief appropriate to Guam without distorting the basic taxing structure.") The difference is that Guam's exemption is the result of Congressional action, whereas tax treaties are negotiated by the executive department of the U.S. government.

Interest and dividends received by a Guam corporation are taxed on Guam under Section 11 of the IRC as mirrored to Guam. However, they are taxed only once, not twice. While the regular corporate income tax applies, the Guam withholding tax does not apply to foreign (i.e. non-Guam) source income. This is based on § 861(a)(1)(B) of the IRC as mirrored. Under § 816(a)(1)(B), corporations which have 80% or more "foreign source income" (so-called "80-20 corporations") can pay dividends to foreigners free of any withholding obligations.

In combination, §§ 861 and 881(b) provide a possible avenue whereby a U.S. company, using an intermediary Guam corporation, can obtain foreign source funding for its U.S. operations at a lower cost than is available through domestic sources. The legal manner by which this avenue would most probably be used would be through the sale of so-called "Eurobonds".

Treasury describes this combined effect of §§ 881(b) and 861 as somehow undermining the integrity of the U.S. income taxation system, contrary to the intent of Congress. However, Treasury studiously avoids mentioning that exactly parallel international financing activities take place every week, and have for many years, with the blessing of the Treasury.

In the nineteen sixties the United States government attempted to deal with large deficits in the United States balance of payments by discouraging U.S. investment abroad and encouraging foreign investment in the United States. To permit United States companies to borrow abroad the Department of the Treasury encouraged the creation of off-shore finance companies. Since that time the importance of providing U.S. companies access to the Eurobond market through off-shore financing arrangements has never been questioned. U.S. corporations currently borrow around 40 billion dollars in this manner.

For historical reasons, Eurobonds are issued almost exclusively through the Netherlands Antilles. Congressman Barnard stated in a February 2, 1984 letter to Assistant Secretary Chapoton that, the Netherlands Antilles tax treaty permits abuses (not including Eurobond issues) that cost the U.S. Treasury up to 1 billion dollars annually. For this reason the Treasury has been involved in almost two years of negotiations with the Antilles government to renegotiate the treaty. The Treasury had the right to terminate the Antilles treaty effective 12-31-83 [U.S. Netherlands Antilles, 1955, T.I.A.S. No. 3366, 1956-2 C.B. 1116, as amended, 1964, T.I.A.S. No. 5665, 1965-1 C.B. 624] but failed to exercise that right even though numerous other tax treaties allowing tax abuse were then terminated. The conclusion is inescapable, therefore, that the continuing policy of the Treasury is to promote the use of Eurobonds to provide U.S. companies access to foreign funds and that this access is so important that the Treasury is currently tolerating other unrelated abused in the Antilles in order to preserve the Eurobond channel.

In 1982 leaders in the Government of Guam came to recognize the potential Guam had to act as an alternative to the Antilles and similar "tax haven" jurisdictions. The Sixteen Guam Legislature passed legislation designed to accommodate and regulate this industry. In addition, members of the executive branch, in particular the Department of Revenue and Taxation, in conjunction with private sector representatives, began to develop administrative procedures to facilitate the offering of Guam Eurobonds.

From October to early December 1982, officials of the Government of Guam advised the U.S. Department of the Treasury of the ongoing activities which would lead to the diversion of some of the Eurobond business to Guam.

See Guam Pub. L. No. 16-65, which subjected international finance companies to regulation by the Government of Guam, and Pub. L. No. 16-115, which made various amendments to, inter alia, the Guam corporate and securities laws to accommodate the contemplated international finance activities.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory where the Internal Revenue Code is fully applicable.

All interest and dividend payments made by every bank and corporation on Guam would, therefore, be mandatory reported to the Department of Revenue and Taxation and, therefore, directly available to the Internal Revenue Service.

All investments and interest received and paid by corporations in Guam would be fully reported.

All investments, interest and dividends received by individuals would be fully reported. None of the Congressional committees have studied how much tax revenue is lost by the non-reporting of individual interest and dividends received by individuals through Caribbean tax havens. This loophole would not exist on Guam.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory that is subject to regulation under the U.S. banking laws.

Secret bank accounts, therefore, do not exist.

Laundering of money from drugs and other illegal sources can easily be detected by bank examiners of the Guam Department of Revenue and Taxation, as well as FDIC, FSLC and other federal banking authorities.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory where all the laws safeguarding against the abuses occurring in the Caribbean are fully enforceable.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory where the U.S. District Court of Guam has the Congressionally mandated jurisdiction over the enforcement of the Internal Revenue Code and its mirrored territorial income tax.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory where the Department of Justice and the Federal Bureau of Investigation have full jurisdiction to investigate and prosecute any violations of all U.S. laws applicable to Guam.

Guam is the best alternative site for Eurobond financing because it is the U.S. territory located closest to Asia and especially Hong Kong which makes it a convenient relocation site for all activities in the Netherlands Antilles as well as the investment opportunities that are leaving Hong Kong in anticipation of the return to Chinese Rule in 1997.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory therefore, all investments made on Guam would not contribute to our country's ever growing trade deficit and would, therefore, improve the overall picture of the U.S. balance of trade.

Guam is the best alternative site for Eurobond financing because it is a U.S. territory heavily dependent on federal grants and a reduction in said dependence would alleviate the burden of the U.S. Treasury thereby contributing to a reduction in our country's ever growing national deficit.

Mr. Chairman, if this committee is indeed sincere about focusing on other alternatives which may assist domestic borrowing needs without damaging other aspects of the U.S. economy, or increasing tax non-compliance, then Guam is the answer.

Mr. Chairman, I have taken the liberty of appending to my statement a brief prepared by my counsel in our suit against the U.S. Treasury regarding our § 881(b) authority.

I have also taken the liberty of appending a page from the National Governors' Association's Policy Positions 1983-1843, which includes a resolution on international finance subsidiaries passed by the National Governors' Association at its summer meeting in Maine last August, 1983. The resolution read as follows:

"The National Governors' Association endorses the use of international finance subsidiaries to provide the capital needed to establish new industries, enhance our country's economy and improve our gross national product."

"The National Governors' Association recommends that the U.S. government encourage the establishment of international finance subsidiaries in U.S. territories, where such is authorized by statute, before it consummates any tax treaties with foreign jurisdictions to do the same."

I do hope that this committee considers this resolution and this testimony in the vein they were intended that being to provide a constructive alternative that would be beneficial to the U.S. economy. Again, thank you for this opportunity. I stand ready to answer any questions you may have.

Mr. **Jenkins**. Thank you very much, Governor.

We would be delighted to hear from you now, Mr. Speaker.

STATEMENT OF HON. CARL T.C. GUTIERREZ, SPEAKER, LEGISLATURE OF GUAM

Mr. **Gutierrez**. Thank you. My name is Carl Gutierrez. I am the Speaker of the 17th Guam Legislature. I thank you for allowing me the opportunity to testify today, Mr. Chairman.

I am here today to make two essential points on the issue of Guam's economic status as it relates to the Federal Government of the United States.

First, as you are well aware, in 1972, Congress gave Guam the opportunity to establish a financial center, similar in concept to that of the the Netherlands Antilles.

A year and a half ago, just as Guam was about about to launch this new money market on American Guam, the Department of the Treasury stopped it with an arbitrary ruling. The Netherlands Antilles, a foreign entity, continues to make money on their financial center, while American Guam is forced to come here and ask Washington for a handout.

We also understand that language in this year's tax bill, both in the House and the Senate, may make this point moot by eliminating or phasing out the 30-percent withholding clause anyway. We take no position on modification of the withholding tax; what we ask is equal treatment for Guam.

We are suggesting that Guam should be given today what the Netherlands Antilles has today, and then any changes in the tax treaty with the Netherlands Antilles can be made automatically applicable to Guam when and if that neogitation ever ends.

This solution should be acceptable to both Congress and the administration, as well as the people of Guam. As a matter of principle, it is our position that whenever the United States of America enters into tax treaty negotiations with a foreign entity, then all of the flag territories should be taken into account in consideration, and they should be receiving the same benefits as those foreign countries.

We Americans—Americans who have no vote on the floor of Congress and no vote for President—we Americans still deserve fair treatment on taxation. In our opinion, any tax law that supports one of our foreign neighbors against us, and thereby deprives us of that tax revenue is, in effect, taxation without representation.

The second point I have to make is one of logic, a point that I believe should become an axiom surrounding any discussion of Federal support for Guam. Guam is unique among flag territories, in that the U.S. Federal Government, primarily through the Department of Defense, controls over one-third of the island's best land. With that given, it should be clear that it is absolutely impossible for Guam ever to become—ever to be economically self-sufficient, although we admit that our neophyte governments are inefficient.

I challenge any economist to prove that the Federal Government is not inefficient, or that Guam can become economically self-sufficient when somebody who does not pay property taxes owns one-third of the island. Every year we hear the military and Federal officials tout the newest statistics on Federal expenditures on Guam. This year Guam was supposedly the fifth highest in the United States in per capita expenditures of Federal funds. It makes it sound like we are all getting fat on the Federal dollar.

However, if you look at the other side of those statistics, you will see that Guam also has one of the lowest per capita incomes of any American community. These two facts can only be reconciled by analyzing where those dollars do go, if not to the Guamanians.

The contracts for construction on various military installations go to foreign companies. The Federal salaries go directly into commissaries and exchanges that sell everything at federally subsidized prices. The Federal employees live in federally owned housing, some of which is unnecessarily sitting on Nimitz Hill, occupying some of the most valuable land on the island, and without paying property taxes.

The Navy still controls the power system. They claim ownership over the Fena Water Resevoir and the Air Force will not allow public access to privately owned beaches near Andersen Air Force Base.

This list could go on for several pages, Mr. Chairman. The point is, and I hope that Congress will agree, that there is absolutely no way that Guam can ever be economically self-sufficient, no matter how hard it tries and no matter how much it taxes the people or cuts back public services.

Congress is going to have to make a commitment, a long-term commitment, to financially support Guam's infrastructural development. This does not necessarily mean only direct financial support, but mandating that the administration sit down with Guam, on Guam, to restructure the Federal laws that now pertains to Guam. Together we must restructure these laws that now prevent Guam from maximizing what potential for economic development it does now have.

The businessmen of Hong Kong and Taiwan are begging for the opportunity to get their dollars out of their country before communism swallows them. For them, with their ethnic background, Guam is the ideal place to relocate. They are deterred from doing so now because of antiquated income tax laws and immigration laws that Guam is forced to obey.

The U.S. income tax laws were developed when the United States was an exporter. Guam never has been an exporter, and still imports nearly everything it needs, and Guam's tax law should be adjusted to take that reality into account. For instance, if a Guamanian buys a Datsun, the Datsun Co. makes approximately $1,000 in profit, and the people of Japan make about $1,000 in export taxes. Are we supposed to tack another $1,000 import tax on that, just to generate revenues for our general fund?

What should happen is that Guam should receive half of that tax benefit now going to Japan, by deeming it a foreign tax and charging it against Japan's foreign tax debt. In that way the Guam consumer pays the same price for the vehicle, but the Island of Guam shares the tax revenue with Japan, a significant benefit to America as well as decreasing Congress' financial obligation to Guam.

Guam should have tax autonomy, and whatever difference may arise between the tax laws of Guam and the Commonwealth of the Northern Mariana Islands can be worked out between the two respective governments.

I know that this is not the forum, Mr. Chairman, but I must reiterate that Guam must also have certain control over its own immigration if it is every to maximize potential for its tourist trade.

Again, I ask Congress to accept the responsibility for equity for Guam and the flag territories in all American tax treaties, and that Congress should accept as a basic premise that as long as the Federal Government continues to control one-third of the island's natural resources, Guam can never be expected to become fully economically self-sufficient.

The Congress should make a long-term commitment to the continued economic development of Guam and mandate that the various branches of the Federal Government which have responsibilities on Guam work closely with Guam officials to ensure that whatever economic potentials Guam does have should be fully exploited. Primary among these Federal agencies should be the Treasury and Immigration and Naturalization Service.

Guam should be developed as the model of American democracy and capitalism in the Western Pacific, not just the model military installation, Mr. Chairman.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF SPEAKER CARL T.C. GUTIERREZ, 17TH GUAM LEGISLATURE

Good day members of Congress, my name is Carl T. C. Gutierrez and I am the Speaker of the Seventeenth Guam Legislature. I thank you for allowing me the opportunity to testify today.

I am here today to make two essential points on the issue of Guam's economic status as it relates to the Federal Government of the United States.

First, as you are well aware, in 1972 Congress gave Guam the opportunity to establish a financial center similar in concept to that of the Netherlands Antillies. A year and a half ago, just as Guam was about to launch this new money market, on American Guam, the Department of the Treasury stopped it with an arbitrary ruling. The Netherlands Antillies, a foreign entity, continues to make money on their financial center while American Guam is forced to come here and ask Washington for a hand out.

We also understand that language is in this year's tax bill both in the House and the Senate that may make this point moot by eliminating or phasing out the 30% withholding clause anyway. Nevertheless, if it remains a part of Federal law, we are suggesting that Guam should be given today, what the Netherlands Antillies has today, and then any changes in the tax treaty with the Netherlands Antillies can be made automatically applicable on Guam when and if that negotiation ever ends. This solution should be acceptable to both Congress and the Administration as well as the people of Guam.

As a matter of principle, it is our position that whenever the United States of America enters into tax treaty negotiations with a foreign entity, then all of the flag territories should be taken into consideration and they should receive the same benefits as those foreign countries. It is only fair that we Americans—Americans who have no vote on the floor of Congress and no vote for president—we Americans still deserve fair treatment on taxation. In our opinion, any tax law that supports one of our foreign neighbors against us and thereby deprives us of that tax revenue is in effect "taxation without representation."

The second point I have to make is one of logic, a point that I believe should become an axiom surrounding any discussion of Federal support for Guam.

Guam is unique among flag territories in that the United States Federal Government, primarily through its Department of Defense, controls over one-third of the island's best land. With that given, it should be clear that it is absolutely impossible for Guam ever to be economically self-sufficient. Although we admit that our neophyte governments are inefficient, I challenge any economist to prove that the Federal government is not inefficient, or that Guam can become economically self-sufficient when somebody who doesn't pay property taxes owns one-third of the island.

Every year we hear the military and federal officials tout the newest statistics on Federal expenditures on Guam. This year, Guam was supposedly the fifth highest in the United States in per capita expenditures of Federal funds. It makes it sound like we are all getting fat on the Federal dollar. However, if you look at the other side of those statistics, you will see that Guam also has one of the lowest per capita incomes of any American community. These two facts can only be reconciled by analyzing where those dollars do go, if not to the Guamanians.

The contracts for construction on the various military installations go to foreign companies. The Federal salaries go directly into commissaries and exchanges that sell everything at federally subsidized prices. The Federal employees live in federally-owned housing, some of which is unnecessarily sitting on Nimitz Hill occupying some of the most valuable land on the island, and without paying property taxes. The Navy still controls the power system. They claim ownership over the Fena Water Reservoir and the Air Force will not allow public access to privately-owned beaches near Andersen Air Force Base. This list could go on for several pages.

The point is, and I hope that Congress will agree, is that there is absolutely no way that Guam can ever be economically self-sufficient no matter how hard it tries and no matter how much it taxes the people or cuts back public services. Congress is going to have to make a commitment, a long-term commitment, to financially support Guam's infrastructural development.

This does not necessarily mean only direct financial support, but mandating that the Administration sit down with Guam, on Guam, to restructure the Federal laws that now pertains to Guam. Together, we must restructure these laws that now prevent Guam from maximizing what potential for economic development it does now have.

The businessmen of Hong Kong and Taiwan are begging for the opportunity to get their dollars out of their country before communism swallows them. For them, with their ethnic background, Guam is the ideal place to relocate. They are deterred from doing so now because of antiquated income tax laws and immigration laws that Guam is forced to obey.

The U.S. Income Tax Laws were developed when the United States was an exporter. Guam never has been an exporter and still imports nearly everything it needs, and Guam's tax laws should be adjusted to take that reality into account.

For instance, if a Guamanian buys a Datsun, the Datsun company makes approximately $1,000 in profit and the people of Japan make about $1,000 in export taxes. Are we supposed to tack another $1,000 import tax on that just to generate revenues for our General Fund?

What should happen is that Guam should receive half of the tax benefit now going to Japan by deeming it a foreign tax and charging it against Japan's foreign tax debt. In that way, the Guam consumer pays the same price for the vehicle, but the island of Guam shares the tax revenue with Japan, a significant benefit to America as well as by decreasing Congress' financial obligation to Guam.

Guam should have tax autonomy, and whatever difference may arise between the tax laws of Guam and the Commonwealth of the Northern Mariana Islands can be worked out between our two respective governments.

I know that this is not the forum, but I must re-iterate that Guam must also have certain control over its own immigration if it is ever to maximize the potential for its tourist trade.

Again, I ask Congress to accept the responsibility for equity for Guam and the flag territories in all American tax treaties, and that as long as the Federal Government continues to control one-third of the island's natural resources, Guam can never be expected to become fully economically self-sufficient.

The Congress should make a long-term commitment to the continued economic development of Guam and mandate that the various branches of the Federal Government, which have responsibilities on Guam, work closely with Guam officials to ensure that whatever economic potentials these Federal agencies should be the Treasury and Immigration and Naturalization Services.

Guam should be developed as "the" model of American democracy and capitalism in the Western Pacific. Not just the model military installation.

Thank you.

Mr. JENKINS. Thank you, Mr. Gutierrez.

Mr. GUARINI. I have no questions, except to thank the gentlemen from Guam for their clear and concise statement. Thank you, sir.

Mr. JENKINS. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. I want to thank the Governor and the speaker and your representative. I think you have raised some real interesting questions, very important questions, and I think those are issues that we do need to explore. It seems to me that you are only asking for fairness and equity. I want to thank you for coming in that spirit before the committee.

Thank you, Mr. Chairman.

Mr. JENKINS. Mr. Frenzel.

Mr. FRENZEL. Mr. Chairman, I would make the same comment. We do not often have the counsel of such distinguished representatives in an area that we have had today—the Governor and the speaker of the house—and, of course, they come well represented by our friend Tony, and we appreciate having their counsel and hope that we can bring it to bear in an effective method.

Thank you very much.

Mr. JENKINS. I want to thank you, Mr. Won Pat, Governor, and Mr. Speaker for appearing before the committee, and I want you to know that your testimony will all be read and considered by the other members of the committee before the conference takes place.

Thank you very much for coming.

Mr. WON PAT. Thank you, Mr. Chairman and members.

Mr. JENKINS. Our next panel of witnesses, officials of the Government of the Netherlands Antilles, Prime Minister Martina; Paul A. Laudicina, the director of the International Policy Analysis Group; the Honorable Gilbert de Paula, Minister of Finance; and the Honorable Harold Henriquez, Minister Plenipotentiary in Washington.

Mr. Prime Minister, we are delighted to have you and other government officials before the committee today, and we will at this time be delighted to hear from you.

STATEMENT OF HON. DOMINICO F. MARTINA, PRIME MINISTER OF THE NETHERLANDS ANTILLES, ACCOMPANIED BY HON. GILBERT DE PAULA, MINISTER OF FINANCE; AND HON. HAROLD HENRIQUEZ, MINISTER PLENIPOTENTIARY IN WASHINGTON

Prime Minister MARTINA. Thank you, Mr. Chairman.

Mr. Chairman, distinguished members of the House Ways and Committee, I am Dominico Martina, Prime Minister of the Netherlands Antilles. I am accompanied by Mr. Gilbert de Paula, our Minister of Finance; Mr. Paul Laudicina, of the firm SRI International; and Mr. Harold Henriquez, our Minister Plenipotentiary in Washington.

Mr. Laudicina is testifying at our request as an expert witness.

It is a sincere pleasure for me to appear before you this afternoon. We in the Caribbean Basin know of the strong interest this committee and in particular this chairman has evidenced in our welfare. Was it not for your leadership, the Caribbean Basin Initiative would still be but a dream.

Mr. Chairman, I know it is unusual, it is very unusual for the head of government to appear before you, and I am grateful for this opportunity. I would not have traveled here to Washington, were it not for the critical importance of the issues before this committee to the future of my country.

The close alliance between our two countries is one of the longest enduring in the Western Hemisphere, dating back to the Revolutionary War, and during World War II the Netherlands Antilles was of strategic importance to the United States. American troops and aircraft were stationed there. Oil refined in the Netherlands Antilles fueled Allied operations in World War II and during the Korean war.

Also, we were of great importance and help to the United States in the 1973 oil embargo. Adding to the current strategic importance of the Netherlands Antilles are four large and modern air strips, two of which have runways approximately 10,000 feet each. I need not remind this committee of the strategic importance of such facilities in the Caribbean Basin.

Mr. Chairman, we are at the critical time in our history and the action that your Government and your committee take will have a direct effect on whether or not we shall overcome that crisis. Ironically, the crisis we face today results from our cooperation with the United States during a critical period for your country. It was during the time of the United States balance-of-payment crisis in the 1960's that it was important for the United States to have a conduit, whereby foreign capital could flow into the United States. The Netherlands Antilles finance subsidiaries mechanism was established as a means for the U.S. multinational enterprises to obtain low-cost foreign capital. This was directly encouraged by the United States through a series of administrative actions, including IRS rulings and SEC no-action letters.

The use of Netherlands Antilles finance subsidiaries grew into an efficient and reliable system.

The basic infrastructure of the Netherlands Antilles developed in reliance on our international financial sector, continuing to be the major contributor to our economy. At the present time, at least 25 percent of our combined federal and Curacao budget results from treaty-related activities with the United States.

Let me repeat, Mr. Chairman, that currently 25 percent of these entire budgets are generated through the direct tax revenues we receive from international companies whose existence largely depends on the treaty relationship that exists between our two countries. This does not take into account the indirect revenues resulting from increased employment and support services.

It is important to understand that contrary to the claim of some of our detractors, this does not translate into a dollar-for-dollar revenue loss to the United States. The U.S. revenue cost is much less and tends toward the minimum; in contrast, the repeal of legislation before you, according to the Senate report, will cost the U.S. Government approximately half a billion dollars over the next 5 years. This is contrasted with other provisions already in your tax bill which Treasury has lumped into its revenue estimates.

Upon the request of the U.S. Treasury, we have been actively renegotiating the existing treaty over the last 3 years. Very few issues remain to be resolved. In December, our Finance Minister, Mr. de Paula, made a special trip to the United States with specific instructions to do whatever possible to conclude the treaty negotiations.

Most recently, I myself met again with the U.S. Treasury Department on April 6. At that time, I told them I thought it both a matter of elemental fairness and critical importance that we conclude our negotiations prior to this hearing. I again offered to make available our Finance Minister for the entire week of your congressional Easter recess. We have yet to receive any response.

While we hesitate to directly comment on domestic legislation being considered by the U.S. Congress, I am informed that the proposals now before you will provide an alternative to the Netherlands Antilles finance company. The existing system works fine, and as you say in your country, if it is not broken, don't fix it.

In performing its duty, the U.S. Congress might consider the following points in deciding which alternative is preferable. The Netherlands Antilles finance company has served to raise Eurodollars for U.S. companies for over 20 years in an efficient manner, and the legislation might result in a much less effective substitute;

the Netherlands Antilles finance company would continue without any additional cost to the U.S. Treasury; the finance company provisions of the new treaty have been substantially agreed upon and will continue existing practice with more certainty.

The treaty, rather than the legislative route, will assist the economy of a friendly Caribbean nation which is in difficult economic straits, while allowing us to improve our law enforcement system in the United States. If the treaty is concluded, we expect it to be a landmark that both governments will point to with pride as establishing new frontiers in international economic and law enforcement cooperation.

The Netherlands Antilles is already recognized as one of the most cooperative U.S. allies in the Caribbean. As evidence of this, I would like to submit for the record a package of letters, including one from Congressman Stark and a copy of a recent award given us by your Attorney General.

Mr. Chairman, I would like to state what has been said by the Attorney General of the United States. As I heard what has been said by the previous witness, I would like to quote words of Mr. Smith, the Attorney General of the United States. He said:

> On this occasion I want to express our appreciation and special gratitude to you, Mr. Attorney General, for the exemplary cooperation and assistance you have extended over the course of many years to the United States law enforcement agency. In so many instances you have provided valuable intelligence information and documentary evidence in criminal areas in the areas of narcotics trafficking and organized crime. You have demonstrated in a very real and concrete way that you not only share our deep concern over the flow of illegal drugs into both your country and ours, but have also taken strong, courageous, and effective measures to stem this flow. This assistance you have provided us has contributed in a most significant way to the success of our enforcement program against narcotics trafficking and organized crime.

Mr. Chairman, I also have to inform you that in negotiations with the Treasury Department, we have agreed to amend our bearer shares and bank secrecy laws by virtue of the new treaty, so as to provide the most far-reaching exchange of information provision ever contained in a U.S. tax treaty.

So, in conclusion, Mr. Chairman, and members of this committee, as I have stated, we currently face a crisis. Failure to conclude negotiations on a revised tax treaty with your country will severely damage our economy and could destablilize our social and political life.

Obviously, the legislation before you has also the potential to make such a treaty irrelevant and bring about the crisis we so desperately seek to avoid. Both the legislation before you and the tax treaty with my country are attempts to achieve much the same result. The difference is that by allowing the tax treaty to provide access to the Eurodollar market, you will permit and confirm a proven channel, one that has functioned at nominal revenue loss to the United States, and at the same time you will help a staunch ally in the Caribbean Basin to maintain economic and political stability.

On the other hand, the legislative proposals will cost the United States approximately half a billion dollars over the next 5 years, while destabilizing my country. This legislation will also seem to conflict with the goals of the Caribbean Basin Initiative, and certainly with the philosophy underlying the CBI, and that is to secure political stability in the Caribbean Basin.

I hope I have made it clear that the fate of my country hangs in the balance, awaiting a decision by your committee and by your Government as to whether or not you continue to value the services we have provided through our treaty relationship. We hope you will take this into account as you make your decisions.

Thank you, Mr. Chairman. And now I would like Mr. Laudicina to summarize the SRI Report, and then we will all be available for your questions. Thank you.

Mr. JENKINS. Thank you, Mr. Prime Minister.

We will now hear from Mr. Laudicina.

Prime Minister MARTINA. I would like to submit these documents to you also, Mr. Chairman.

Mr. JENKINS. Without objection, they will be made part of the record.

[The prepared statement and attachments follow:]

STATEMENT OF DOMINICO F. MARTINA, PRIME MINISTER OF THE NETHERLANDS ANTILLES

INTRODUCTION

Mr. Chairman, distinguished Members of the House Ways and Means Committee, I am Dominico F. Martina, Prime Minister of the Netherlands Antilles. I am accompanied today by Gilbert de Paula, our Minister of Finance, Paul Laudicina of the firm SRI International, and Mr. Harold Henriquez, our Minister Plenipotentiary in Washington. Mr. Laudicina is testifying at our request as an expert witness. He has a brief statement discussing a report they did on the impact of international financial activities in my country. He will also be available for questions as will Finance Minister de Paula and Mr. Henriquez, who has represented our Government in the on-going treaty negotiations with the U.S. Department of the Treasury.

It is a sincere pleasure for me to appear before you this morning. We in the Caribbean Basin know of the strong interest this Committee and particularly its Chairman has evidenced in our welfare. But for your leadership, the Caribbean Basin Initiative would still be but a dream. We are most grateful to you for your effort and sincerely hope that the CBI will develop into a useful tool in addressing the social and economic problems of the Caribbean Basin. While it is unfortunate you were not able to visit my country on your last official visit to the region, we look forward to welcoming you to it on your next one.

The Netherlands Antilles is made up of six islands in the Caribbean Basin area. Aruba, Bonnaire and Curacao are located approximately 30 miles north of Venezuela. St. Maarten, St. Eustatius and Saba are about 500 miles further northeast—approximately 100 miles east of Puerto Rico. The total area is about 394 square miles and the population is slightly more than 250,000.

UNITED STATES/NETHERLANDS ANTILLES ALLIANCE

The close alliance between our two countries is one of the longest enduring in the western hemisphere, dating back to the Revolutionary War, when my country served as a funnel for European supplies to General George Washington. The alliance has been one of the strongest between the United States and any Caribbean nation.

We have come to the assistance of the United States several times in periods of crisis in your country. During World War II the Netherlands Antilles was of strategic importance to the United States; American troops and aircraft were stationed there; the troops to protect critical refineries on Aruba and Curacao and the aircraft to protect South Atlantic shipping against enemy submarines. Oil refined in the Netherlands Antilles fueled allied operations in Africa, Normandy and the Pacific during World War II and was again especially important to the United States during the Korean War and the 1973 oil embargo. Most recently, the Netherlands Antilles has extended extensive and regular assistance to the United States to interdict illegal drug trafficking.

Adding to the current strategic importance of the Netherlands Antilles are four large and modern airstrips, two of which have runways of approximately 10,000 feet each. I need not remind this Committee of the strategic importance of such facilities in the Caribbean Basin.

Since 1954 the Netherlands Antilles has been an autonomous part of the Kingdom of the Netherlands. Full independence for at least one of the islands is projected for the mid 1990s.

THE NETHERLANDS ANTILLES FINANCE SUBSIDIARY

We now are at a critical time in our history and the actions that your Government and your Committee take in the next several years will have a direct effect on whether or not we shall overcome that crisis. Ironically, the crisis we now face in large part results from our cooperation with the United States during a critical period for your country.

During the United States balance of payments crisis in the 60s, it was important for the United States to have a conduit whereby foreign capital could flow into the United States. The existing tax treaty relationship between the United States and the Netherlands Antilles was recognized as having the potential to become that conduit. As a result, the mechanism of the Netherlands Antilles finance subsidiary was established as a means for United States multinational enterprises to obtain low cost foreign capital. This was directly encouraged by the United States through a series of administrative actions, including IRS rulings and SEC no-action letters. The use of Netherlands Antilles finance subsidiaries grew into an efficient and reliable system.

Because of the other limitations on our economy, which Mr. Laudicina will outline in his statement, the basic infrastructure of the Netherlands Antilles developed in reliance on our international financial sector continuing to be the major contributor to our economy. Some 200 U.S. corporations have used its provisions since 1973 to access over $31 billion in Eurobonds. At the present time at least 25 percent of our combined federal and Curacao budget results from treaty related activities with the United States. (See Attachment I). Let me repeat—currently 25 percent of these entire budgets is generated through the direct tax revenues we receive from international companies whose existence largely depends upon the relationship that exists between our two countries. In 1983, these direct revenues amounted to $157 million U.S. This does not take into account the indirect revenues resulting from increased employment and support services.

It is important to understand that, contrary to the claim of some of our detractors, this does not translate into a $157 million revenue loss to the United States. Our 30 percent tax is based on an interest spread earned by these finance subsidiaries. From the U.S. point of view it should be recognized that this spread is a creation of our law, the amount of which is limited pursuant to an understanding with our Treasury, and would not exist but for the treaty route for finance companies. Moreover, through the mechanics of your additional subpart F this additional income is currently reportable as additional income of the U.S. parent company, potentially taxable at the standard 57 percent U.S. corporate rate.

In short, for every one hundred dollars of interest spread earned by the Antilles finance subsidiary, there is a thirty dollar Antilles income tax, creditable against U.S. tax, but there is also an additional forty-six dollars of U.S. tax which would not be otherwise be present. This is an oversimplification and, under current law, due to the intracacies of your foreign tax credit there probably is some revenue loss to the United States under the present system, but this small revenue loss would be eliminated under the new tax treaty which is now near agreement. In contrast, the repeal legislation before you would cost the U.S. Government approximately half a billion dollars over the next five years.

REASONS FOR CRISIS

As I stated earlier, we now face a crisis and we are calling upon you for your help. Because of various perceived problems with the current tax treaty, the United States Treasury put us on notice over three years ago that they felt it necessary to renegotiate the existing treaty. We have been actively negotiating with the Treasury Department over that entire period. Recently, at my Government's request, our Finance Minister, Mr. Gilbert de Paula, made a special trip to the United States in December of last year with specific instructions to do whatever possible to conclude the treaty negotiations.

Most recently, I myself met again with the U.S. Treasury Department on April 6. At that time I told them I felt it both a matter of elemental fairness and critical importance that we conclude our negotiations prior to this hearing. I again offered to make available our Finance Minister for the entire week of your Congressional Easter Recess. Despite assurances that our position was understood and that we would be notified by the Treasury Department as to how they planned to proceed, we have yet to receive any response. Therefore, I regret to inform this Committee that it has not yet been possible to conclude these negotiations.

It is our impression that the possibility that the various legislative proposals under discussion before this Committee today might pass may have affected the willingness of the United States Treasury Department to conclude the negotiations. We continue to stand ready to meet around the clock if necessary with your government to resolve the remaining issues. Indeed, the remaining issues are few. We have agreed on the basic substantive provisions of the new treaty which would eliminate the so-called treaty shopping abuses (although the details of two provisions have to be finalized) and are in the process of accommodating the United States in developing the most comprehensive and far reaching exchange of information agreement ever establish between two countries.

We are prefectly satisfied with the existing treaty. As your press has reported, the recent action by the Senate Finance Committee was enough to throw this efficiently functioning market into disarray, immediately disrupting at least 15 Eurobond offerings worth over $1 billion. While we are willing to renegotiate the existing treaty to remedy any perceived abuses, we think the proponents of any changes beyond that should bear a strong burden of proof. The existing system works fine. I understand there is an expression in your country: "If it's not broken, don't fix it." The other proposals before you today would at the same time cripple our economy and cost your country revenue with no guarantee they will work any better and some concern that they will be worse.

PROPOSED LEGISLATION AS ALTERNATIVE TO NETHERLANDS ANTILLES FINANCE COMPANIES

While we hesitate to directly comment on domestic legislation being considered by the United States Congress, I am informed that the proposals now before you will provide an alternative to the Netherlands Antilles finance company. In performing its duties the United States Congress might consider the following points in deciding which alternative is preferable:

The Netherlands Antilles finance company has served to raise Eurodollars for the United States economy for over twenty years in an efficient manner and, as stated below, the legislation might well result in a much less effective substitute;

The Netherlands Antilles finance company would continue without any additional cost to the United States Treasury, as compared to the proposed legislation which would result in a substantial U.S. revenue loss;

The finance company provisions of the new treaty have been substantially agreed upon and will continue existing practice with more certainty;

The new treaty will address the ongoing audit problems raised under the existing treaty;

The treaty, rather than the legislative route, will assist the economy of a friendly Caribbean nation which is in difficult economic straits;

The treaty would continue a major source of our government revenue, substantial employment, and other economic benefits, the absence of which will threaten the stability of a strong and strategic Caribbean ally of the United States; and

The new treaty will make it possible for us to improve our law enforcement assistance to the United States.

While it is not possible in the context of this relatively brief statement to respond to every allegation that has been made concerning the present system, I would like to make a brief observation concerning the allegation that the use of Netherlands Antilles finance subsidiaries is a unique and artificial structure. It is certainly not unique; there are probably a half dozen or more U.S. tax treaties that could be used for the same purpose. As to the supposed artificiality of the system, I am advised that it is a basic tenet of your tax system that U.S. companies are permitted to isolate international activities in foreign subsidiaries to legitimately avoid current U.S. taxation of income arising from those activities. The use of Netherlands Antilles finance subsidiaries is, in effect, an application of that basic tenet—not fairly or objectively called unique or artificial.

It is our belief that if the legislation adopted by the Senate were enacted, for the next 4½ years the cost to United States corporations to access the Eurobond market would be increased. This arises due to the interaction of the phase-out of the 30 percent tax with the changes in the resourcing rules. On a permanent basis the legislation might well eliminate the interest savings now available.

Therefore, in considering the legislation before you, you must also be aware that there are other changes contemplated in the pending tax bills—the Resourcing Rules—that may soon go to conference, that interact with the N.A. treaty and the proposals here before us. These concerns can either be addressed legislatively in conference, or presuming the end result contemplates continuation of Netherlands Antilles finance subsidiaries, in the context of a new treaty.

If a new treaty is concluded we expect it to be a landmark that both governments will point to with pride as establishing new frontiers in international economic and law enforcement cooperation.

The Netherlands Antilles is already recognized as one of the most cooperative United States allies in the Caribbean Basin. Specifically, I would like to submit a package of six letters to the Committee, including one from Congressman Stark to Congressman Gibbons and ask that they be made a part of the record of this hearing. Additionally, I take pride in informing the Committee that the Attorney General of our country, Dr. Luis R. Nahr, only last month was honored by your Attorney General through the presentation of an award recognizing the unique contribution the Netherlands Antilles law enforcement coummunity has made and continues to make in the prevention of trafficking in illegal drugs. I would also like to submit to the Committee the remarks made by your Attorney General Smith at that time. In addition to this high level of cooperation that we provide under the current treaty, we have already agreed to amend our bearer share and bank secrecy laws by virtue of the new treaty so as to provide the most far reaching exchange of information provisions ever contained in a United States tax treaty.

CONCLUSION

Mr. Chairman and Members of the Committee, as I have stated we currently face a crisis. Failure to expeditiously conclude negotiations on a revised tax treaty with your country will severely damage our economy and could destabilize our social and political life. Obviously, the legislation before you also has the potential to make such a treaty irrelevant and bring about the crisis we so desperately seek to avoid.

Both the legislation before you and the tax treaty with my country are attempts to achieve much the same result. The difference is that by allowing the tax treaty to provide access to the Eurodollar market, you will permit and confirm a proven channel—one that has functioned at nominal revenue loss to the U.S. At the same time you will help a staunch ally in the Caribbean Basin to maintain economic and political stability.

On the other hand, the legislative proposals will cost the U.S. approximately half a billion dollars over the next five years, while destabilizing my country. Additionally, as the attached testimony given before the Senate Finance Committee in 1976 would indicate, there is a serious question as to whether the legislation will bring about the claimed benefits. This legislation would also seem to conflict with the goals of the Caribbean Basin Initiative and certainly with the philosophy underlying the C.B.I.—i.e., "to secure political stability in the Caribbean Basin."

I hope I have made it clear that the fate of my country hangs in the balance awaiting a decision by your Government as to whether or not you continue to value the services we have provided through our treaty relationship. We hope you will take this into account as you make your decisions. Thank you, and now I would like Mr. Laudicina to briefly summarize the SRI report and then we will all be available for your questions.

ATTACHMENT I

N.A. REVENUE

The international finance sector resulted in tax assessments of U.S. $157 million in 1983 ($82 million in 1981 and $129 million in 1982), most of which depend on continued use of the Netherlands Antilles by American multinational corporations for Eurobond issues. This amount constitutes 57% of the Netherlands Antilles Federal budget and 25% of the combined Federal and Curacao budgets. The percentages are even higher in comparison to governmental receipts. The international finance sector is the single largest contributor to government revenues.

The relevant governmental budgets are as follows:

	Federal	Curacao (United States dollars)	Combined Federal-Curacao
1981	196.7	286.6	483.3
1982	241.1	330.8	571.9
1983	275.0	345.9	620.9

ATTACHMENT II

FOREIGN PORTFOLIO INVESTMENTS IN THE UNITED STATES

HEARING

BEFORE THE

SUBCOMMITTEE ON
INTERNATIONAL FINANCE AND RESOURCES

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

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U.S. WITHHOLDING TAX RATES ON INTEREST AND DIVIDENDS INCOME

[In percent]

Recipient	Dividends (Portfolio)	Interest
Nontreaty nations	30	30
Treaty nations:		
Australia	15	30
Austria	15	0
Belgium	15	15
Canada	15	15
Denmark	15	0
Egypt	15	15
Finland	15	0
France	15	10
Germany	15	0
Greece	30	0
Ireland	15	0
Israel	25	17.5
Italy	15	30
Japan	15	10
Luxembourg[1]	15	0
Netherlands	15	0
Netherlands Antilles[2]	15	0
New Zealand	15	30
Norway	15	0
Pakistan	30	30
South Africa	30	30
Sweden	15	0
Switzerland	15	5
Trinidad and Tobago	30	30
United Kingdom	15	0
United Kingdom overseas territories	15	30

[1] These rates are not applicable to Luxembourg holding companies.

[2] These rates are not applicable to holding companies unless certain elections are made.

Senator BYRD. I thank both of you gentleman.

I will ask Professor Musgrave of Northeastern University if she will make her presentation.

STATEMENT OF PEGGY MUSGRAVE, PROFESSOR, NORTHEASTEN UNIVERSITY, BOSTON, MASS.

Ms. MUSGRAVE. Thank you.

Senator BYRD. You perhaps would want to give a summary and then your formal statement could be submitted for the record.

Ms. MUSGRAVE. Yes.

Senator BYRD. You may proceed in any way you wish.

Ms. MUSGRAVE. Mr. Chairman, I would like to thank you for this opportunity to state and to explain my position in opposition to the exemption of the withholding tax on foreign portfolio investments.

I would like to give a brief summary of my reasons for opposing this proposal.

First, it is a widely accepted principle in international taxation that the country of source of income should be allowed a reasonable tax share in the income arising in its borders and accruing to investors abroad.

In fairness to its own domestic taxpayers, who must ultimately bear the revenue cost of this proposal, the United States should not surrender this claim.

This is particularly the case for interest income on which the withholding tax is the only tax collected.

Second, the withholding tax has customarily been modified in tax treaties which the United States has negotiated with other countries and it has proved to be a key factor in the U.S. treaty negotiating position.

Without the tax, the position of the United States in bargaining for reciprocal tax concessions in future tax treaties is likely to be severely undermined.

Third, the principal beneficiaries of the withholding exemption would be private portfolio investors from those countries with which the United States has no tax treaty, largely the oil producing countries and the less developed countries of Latin America and elsewhere.

The exemption in effect would put the United States in a position of being a tax haven to these investors and of encouraging capital flight from the less developed countries.

It is noteworthy in this connection that when the United States was recently in the process of negotiating a tax treaty with one such developing country, the latter requested the United States not to reduce or eliminate its withholding tax for fear of encouraging capital outflow from its own borders.

Furthermore, I believe that elimination of the exemption would discourage extension of U.S. tax treaties with these countries.

Fourth, those portfolio investors resident in countries with well developed income taxes are usually able to credit the U.S. withholding tax against income tax in their own countries, thus completely or very largely offsetting any extra burden occasioned by the tax.

In such cases, removal of the withholding tax simply results in a transfer of revenue from the United States to foreign treasury without much effect on the investors' own tax burden.

It is only for investors from countries with weak or nonexistent income taxes that removal of the withholding tax would represent a substantial reduction in their overall tax burden.

But I do not believe, Mr. Chairman, that the U.S. taxpayer would take very kindly to assuming the revenue cost of the withholding tax exemption for those foreign investors from countries which either do not tax them at all or, if they do so, do not provide the customary foreign tax credit.

Fifth, arguments made on behalf of the exemption largely run in terms of the need to make portfolio investment in the United States more attractive to foreigners and particularly that financed by petro-dollars.

The economic case for increasing the inflow of such funds, much of which is apt to be of a volatile nature, is not a convincing one, especially in view of the sizable revenue cost.

Retaliation by other capital importing countries via competing tax concessions must be allowed for, in which case the gains must be modest.

It is to be noted that although a number of smaller countries now offer a unilateral exemption on some interest payments paid abroad, others such as Germany, Canada, and the United Kingdom do not, but are likely to tip in this direction if the United States should follow the example of other smaller countries.

Sixth, the United States removed the interest equalization tax and other restraints on its own capital outflow on the grounds that in a regime of flexible exchange rates such constraints were no longer needed for balance of payments reasons.

Consistency, it seems to me, requires that similar reasoning b applied to foreign portfolio inflow to the United States, thus leadin to the conclusion that tax concessions are no longer required under flexible exchange rate system.

Furthermore, and perhaps more important, it would seem to me t be a misuse of the tax system, to give tax concessions to capital inflo at the same time as tax preferences are available to U.S. investmen outflow.

Finally, and in my view most importantly, the exemption is likel to add further fuel to what is developing as a growing worldwide ta competition for international capital.

In the process, the equity and integrity of income taxes in man countries of the world is being undermined and the tax collected o investment income, particularly the corporation tax, is undergoin rapid attrition.

The United States played a large part in this tax competition whe it introduced DISC, a tax concession which was followed by retaliator tax incentives to domestic investment in a number of other countrie

The withholding exemption would, I believe, be followed by simil tax reductions in other countries.

The United States should exert leadership in this area to head o what may prove to be a continuous and self-defeating cycle of ta concessions to international capital.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Professor Musgrave.

In both points five and seven of your presentation, you mentione competing tax concessions.

Ms. MUSGRAVE. Yes.

Senator BYRD. What went through my mind in listening to that i whether it would be similar to a situation that I will mention in moment.

About 15 years ago I was chairman of the Virginia Advisor Commission on Industrial Development. So long as I was chairma which was 5 years, I insisted that we not give tax concessions and ta advantages to companies coming into Virginia.

We would treat them fairly but they would not get any special ta treatment in order to encourage them to come into the State.

I felt for one reason it was unfair to the companies already in th State, but for another reason: When one State starts making concessions, then another State ups the ante.

I think you have that all over the United States now. I haven' kept up with it in detail recently, but I think that is about what ha happened.

So, you really don't gain anything by it.

I gather what you are saying in your statement is that on an international scale, you get about the same situation. Is that it?

Ms. MUSGRAVE. Yes. Although, I would say that the dimensio are apt to be much greater on the international scene.

I think what you say is quite correct, Mr. Chairman. I think it is very good analogy, but I do think that in the international conte the problem assumes even greater proportions.

Senator BYRD. Would either Mr. Walker or Mr. Roosa care t comment on that?

Mr. **Walker**. I don't know that the analogy really lies in that direction, Mr. Chairman.

I don't see that this is a competition of a tax incentive or a tax haven, as the example you put in your statement.

Rather, it strikes me as a removal of impediments to the free flow of capital which, if allowed to flow and seek its own level, would find its investment media in whatever the desirable yield potential would be for the investment.

Thus, for example, the investment of money in equities for industries in this country would have the following effects, it seems to me.

It would provide the additional capital needed to improve the degree of productivity of that enterprise in this country that not only produces the jobs and so forth associated with it, but it also produces income from that enterprise which indeed is taxed in the United States.

There is no preference in that sense of the word at all. The investor from abroad is thus spared the withholding tax, but is nevertheless in his own country subject to whatever that country's tax burden is on the yield from that investment.

By removing this impediment, it would have the effect of really treating all foreign investors from whatever country they come equally insofar as investment in our country is concerned.

It is not a piecemeal treatment of these foreign investors.

Senator **Byrd**. I had not seen my colleague, Congressman Fisher, til just this moment. I have just two additional questions in regard to Professor Musgrave's presentation and then I would want to call on the Congressman from Virginia.

In Professor Musgrove's presentation, number one, she says it is a widely accepted principle in international taxation that the country of source of income should be allowed a reasonable share of income arising in its borders but accruing to foreign investors.

Would Mr. Walker or Mr. Roosa comment on that statement?

Mr. **Roosa**. It is not a principle that I have heard. I am not a professor of international or domestic finance, but I certainly have understood the opposite principle, in that this is a distinction between, for example, a tax haven and the situation we are talking about.

I would agree with the Secretary, for example, that this is not analogous to your condition in Virginia at all, because the basic corporate tax is still paid here so far as the dividends are concerned.

The point on interest has a different implication. With respect to the corporate position, the corporation pays full corporate tax here and then the domicile of the resident who receives the dividend, it seems to me, properly determines where he pays that which some people regard as double taxation in any event.

As you know, in many countries still you are taxed on one or the other, but not both, or at least you get a passthrough credit; therefore, I am just not aware of this principle.

It may be in some textbooks, but I have thought instead that the principle was the other way around, that it was the domicile of the taxpayer which determined the situs of the tax liability and that therefore corporations properly should pay taxes where they functioned—and do here—and that recipients, individuals of dividend income, are then subject to tax in their own country.

Senator Byrd. What is the Treasury Department's position o that tax principle?

Mr. Walker. I think Mr. Roosa has expressed it the way I unde stand it, too, Mr. Chairman.

May I add one further thing on the subject of the tax credit

Certainly, the utilization of a tax credit is designed to remove th double tax impact and to produce an aggregate tax liability that i no greater than our own domestic tax liability.

The fact is, I believe, that far fewer countries have a tax cred mechanism than do not have such a mechanism. Indeed, it is m understanding that of the 25 OECD countries, only six of them have credit mechanism.

So, that the relief that is granted in that fashion isn't availabl Otherwise, we have to obtain it by treaty.

Senator Byrd. I think Mr. Roosa has substantiated item three Professor Musgrave's presentation, "The principal beneficiaries of th withholding exemption would be private portfolio investors from tho countries with which the U.S. has no tax treaty, such as the o producing countries."

Then, she said, "In the less developed countries, in Latin Ameri and elsewhere."

Mr. Roosa. I would modify it. If we eliminate the withholding ta the beneficiaries are everywhere.

Senator Byrd. The principal ones should be in the Middle Ea you indicated earlier.

Mr. Roosa. I said the principal additional beneficiaries, apart fro those with whom we have the tax treaties and who would then, course, get the benefit of no tax.

Senator Byrd. Mr. Walker, according to a recent Treasury estima every $1 million foreign investment would produce $100,000 corpora tax revenue in this country.

What is the basis for that estimate?

Mr. Walker. Mr. Chairman, was that $1 million or $1 billion? Senator, I lose track of where the decimal point goes.

May I explain the rationale and how the number was arrived

Senator Byrd. Yes.

Mr. Walker. I think every dollar that is invested from abroad intended to produce yield. That yield in turn is subject to tax in th country.

The numbers that I have been familiar with are that if you assu a 15-percent yield on the investment, and roughly a 50-percent tax the amount of that yield, you have an offsetting revenue gain a result of that investment.

Senator Byrd. Thank you.

If all three of you could stay were you are, if you will, and I will Congressman Fisher to come to the witness table.

STATEMENT OF HUGH J. AULT, PROFESSOR, BOSTON COLLEGE LAW SCHOOL, NEWTON, MASS.

Senator **Byrd**. Perhaps you would want to summarize your statement and the entire statement will be published in the record.

Mr. **Ault**. Thank you, Mr. Chairman. I am pleased to appear before the committee today. Several years ago I received generous support for my research activities under the Fulbright exchange program set up by you and your colleagues and I am delighted to make some contribution in return.

I have presented a statement but I would like to make a few additional points, if I may.

Senator **Byrd**. Your entire statement, without objection, will be placed in the record, and you may proceed to summarize.

Mr. **Ault**. I believe that the material that has been presented so far sets forth the basic arguments here. I would like to try to put those arguments in focus.

As Mr. Roosa indicated, the primary function of the proposed change in the U.S. rule is to attract capital on the theory that we have a capital shortage and need additional foreign investment.

That is a premise with which one could quarrel, but assuming that is true, what will this measure do to attract investment?

Let us focus on the people that it would affect. In the first place, as Congressman Fisher pointed out, for someone investing in the United States from a country which has a foreign tax credit mechanism the reduction in the U.S. tax will have no impact at all with respect to his after-tax rate of return on his investment.

He will simply pay more dollars to his Government and less dollars to our Government. There will be no change in the attractiveness of the U.S. investment to him in any way.

The United States will simply be giving foreign aid, in effect, to the other country which will collect more tax from its citizens than it could otherwise.

What about countries that don't have a foreign tax credit mechanism?

As to those countries, a number of them relieve international double taxation by exempting foreign source income but generally only on the condition that the foreign source income be taxed in the country of source. So, if the United States removes its withholding taxes on that income, again, the foreign country gains, the United States loses, and no investor has been encouraged to invest.

Who then will be encouraged to invest? One, people who don't pay taxes in their own country because they don't declare their income; and for whom the U.S. withholding tax is the only tax, or, second as Mr. Roosa indicated, investors from countries like Israel and other developing countries whom the United States should not be draining capital.

To put it another way, we shouldn't be attempting to attract to our investment market international tax avoiders and investors from less developed countries that need their own capital.

That is basically what this scheme is proposing.

The fourth category of potential investors is the OPEC countries. As was pointed out, these countries themselves are not subject to tax on income. Central banks of issue are not subject to tax on their income. There are some marginal definitional problems about the governmental functions of the foreign investor or the commercial functions of the central bank of issue, but the point is that they are fundamentally exempt from tax. The impact of the 1975 revenue ruling, which Mr. Roosa pointed out, cleared up some peripheral problems in that exemption. It seems to me really is letting the tail wag the dog to change a fundamental principle of U.S. income tax policy simply so that the OPEC countries can be absolutely sure that their income isn't going to be subject to tax.

That is especially significant against the background in which most foreign countries—in Europe, for example, France and Germany—do tax income when derived from portfolio investments by foreign governments.

So, the basic argument that this proposal will attract capital to the United States seems to me at best questionable.

Then the question is, even assuming you have accepted those arguments, what costs will this proposal bring with it?

There has been a lot of discussion with respect to the revenue loss and exactly what its magnitude is. It is clear, however the figures work out, that it will be substantial and that it will not flow primarily to foreign investors but to foreign governments.

Second, we have discussed the decline in the U.S. bargaining power by giving up the ability to impose the withholding tax.

There I think the Treasury has put the role of the withholding rates in a somewhat misleading light. They present it as if we were just tidying up some loose ends by eliminating withholding.

That is not true. Source jurisdiction is the primary jurisdiction in international tax law. All countries tax on a source basis. Sometimes they don't tax their own citizens on foreign source income, but in the evolution of a developing tax system, all countries use source as a jurisdictional base.

The United States has modified its source jurisdiction taxation and has reduced source jurisdiction taxation in treaty negotiations, but only in a negotiated setting, receiving a quid pro quo for U.S. investors in return for reducing its withholding taxes.

That is a second cost in addition to the revenue cost of this proposal.

Third, I think your instinct, Senator, that this would create the kind of tax war of tax concessions in the international context such as you saw in Virginia in the domestic context, is absolutely right.

The question really is, should the United States be a leader in contributing to an unstable international investment situation?

It seems to me by taking the first step in eliminating unilaterally our withholding rates that is clearly what we are doing.

Finally, again as Congressman Fisher pointed out, this provision if enacted, would create substantial inequality in the treatment of U.S. investors with United States source income and foreign investors with the same income.

When Congress passed the Foreign Investors Tax Act in 1966, they set a reasonable balance between the appropriate taxation of foreigners investing in this country and U.S. citizens investing here.

Of course, we don't subject foreigners to a full range of our progressive income tax, but it is perfectly consistent with international tax principles and required by international tax equity that we impose a tax on foreigners who derive their income from the United States.

In summary, it seems to me that the benefits of additional capital investment which this proposal would bring are at best questionable. The costs in terms of revenue loss, treaty bargaining, a tax haven war, and inequity to the U.S. taxpayers are very substantial.

We need a much stronger justification for the benefits that would flow to the United States to undertake this radical change in U.S. international tax policy.

Thank you.

Senator BYRD. Thank you very much, Professor Ault.

[The prepared statement of Mr. Ault follows:]

PREPARED STATEMENT OF HUGH J. AULT, PROFESSOR OF LAW, BOSTON COLLEGE LAW SCHOOL

No Capital Shortage.—The economic evidence with respect to the alleged "capital shortage" which United States business is said to be experiencing is at best inconclusive. The uncertainty of the economic data is certainly not sufficient to justify such a major change in United States tax policy.

Alternative Measures.—Even on the assumption that there does exist a meaningful shortage of investment capital, alternative methods of increasing investment capital are available. The House Bill itself, by increasing the investment credit and through other measures has provided financial stimulus for capital investment. In addition, the present tax preferences given U.S. businesses for their foreign investment could be eliminated or reduced if it is thought necessary to increase further domestic investment.

Measures Would Not Increase Investment.—The assumption behind the proposal to reduce the withholding tax is that by reducing the after tax rate of return for foreign investors, investment in the United States would be increased. This argument overlooks the fact that most foreign countries already provide their citizens or residents relief from the U.S. tax either through a foreign tax credit or by exempting the income from foreign tax if it is subject to tax in the United States. Thus, to eliminate the withholding tax would only result in a revenue loss (estimated at some $1.9 billion over the next five years) which would go directly to foreign governments rather than to foreign investors.

Inconsistent with International Tax Principles.—The basic principles of international tax law clearly allow a country to impose a tax on income arising from activities within its jurisdiction. There is no reason for the United States to unilaterally cede this clearly recognized international right. If the United States takes the lead in eliminating source jurisdiction taxation on portfolio investment income, it could lead to a "tax holiday" competition between capital importing countries to the detriment of all.

Inconsistent with U.S. Treaty Policy.—The U.S. has negotiated over forty conventions for the avoidance of international double taxation in which it has reduced or eliminated its withholding tax on dividends or interest flowing to investors resident in other treaty countries. But in all cases these reductions of withholding rates have been accompanied by a similar reduction in rates imposed by the treaty partner on its source income received by United States taxpayers. Since these foreign taxes would normally have been subject to the foreign tax credit, the United States in its treaty negotiations is in effect recouping the revenue which it loses from giving up the withholding tax on its source income by reducing the amount of otherwise creditable taxes which its citizens would have to pay to foreign government. Why should the U.S. unilaterally give up this revenue to these foreign governments with no *quid pro quo*?

Possibility of Abuse.—The freeing of dividends and interest from withholding taxes would give rise to a number of possibilities for international tax abuse. One can predict with certainty the formation of tax haven foreign corporations to invest in United States securities avoiding all U.S. and foreign taxes.

Equity With United States Citizens.—The Foreign Investor Tax Act, passed by Congress in 1966, sets out the basic U.S. policy with respect to the treatment of foreigners investing in the United States. Congress at that time was concerned with obtaining a proper balance between the taxes paid by our citizens on their United States income and those paid by foreigners on the same income arising here. The Act, consistent with international tax principles generally, taxes foreigners on their business income at the same rates as United States citizens and taxes them on their investment income at the flat 30% rate. Thus the Act recognises that, while the foreign investors should not be taxed at full progressiv rates on his U.S. source investment income, he should make some contribution t the U.S. revenue as part of the price for taking advantage of the investme opportunities in the U.S. To unilaterally eliminate this revenue and shift t burden to United States taxpayers would be inconsistent with the basic requir ments of tax equity between United States and foreign investors.

Senator BYRD. The next witness will be Mr. Tom Frost, presiden of the Frost National Bank of San Antonio, Tex.

SRI International

CLIENT PRIVATE

THE NETHERLANDS ANTILLES: THE IMPACT OF OFFSHORE FINANCIAL ACTIVITIES

September 1982

Final Report

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Prepared for:

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Embassy of the Netherlands
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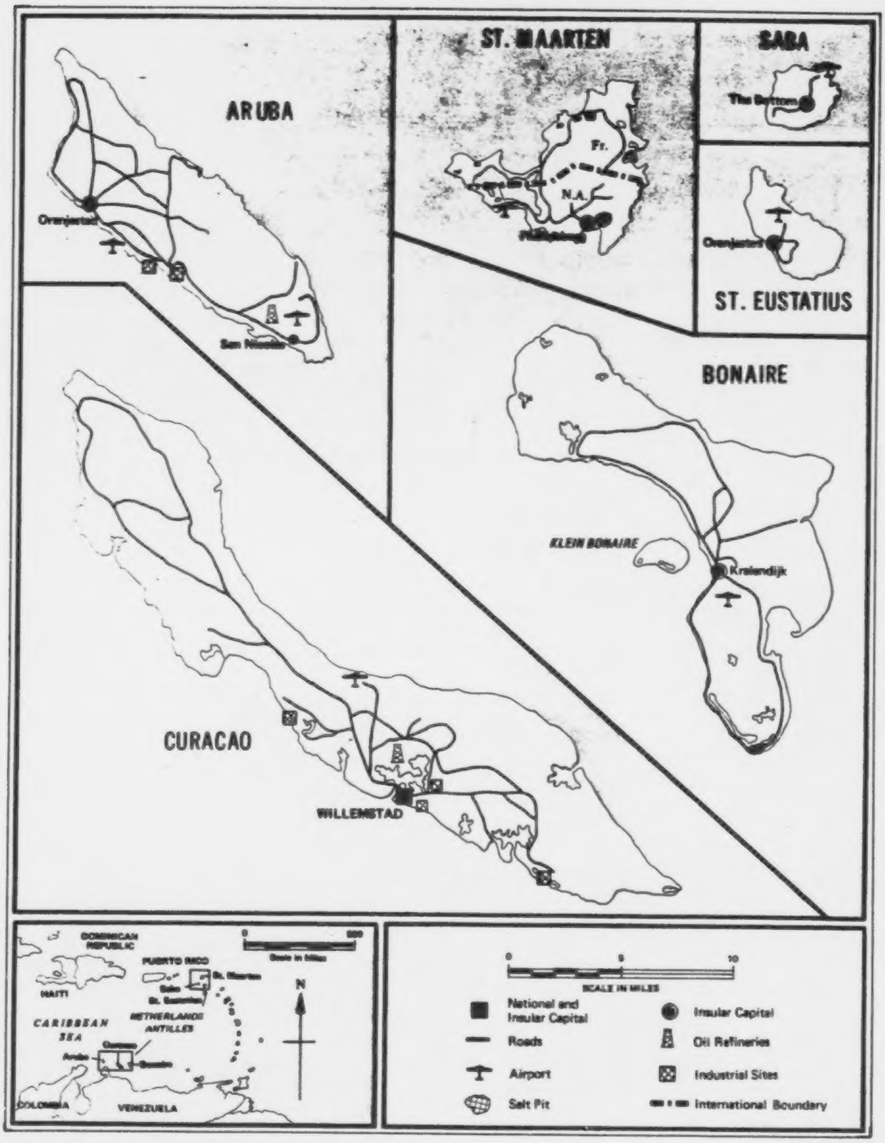
NETHERLANDS ANTILLES

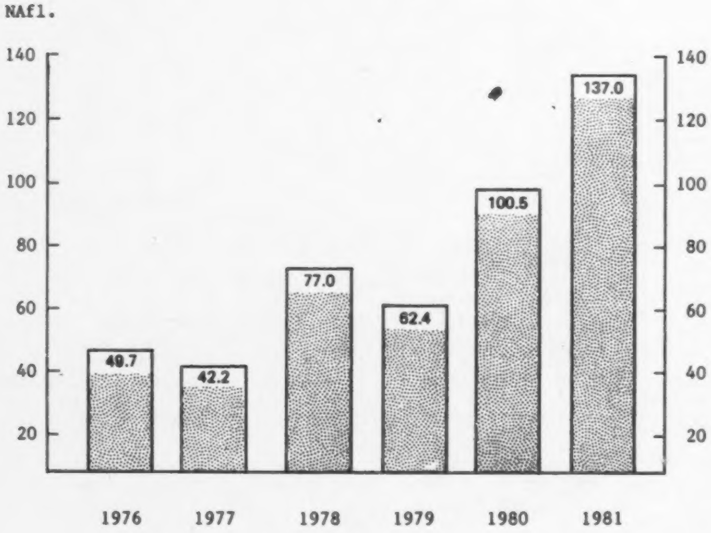

ARUBA
Oranjestad
San Nicolas
ST. MAARTEN
Fr.
N.A.
Philipsburg
SABA
The Bottom
Oranjestad
ST. EUSTATIUS
BONAIRE
KLEIN BONAIRE
Kralendijk
CURACAO
WILLEMSTAD
DOMINICAN REPUBLIC
HAITI
PUERTO RICO
St. Maarten
Saba
St. Eustatius
CARIBBEAN SEA
NETHERLANDS ANTILLES
Curacao
Aruba
Bonaire
COLOMBIA
VENEZUELA
0
200
Scale in Miles
N
0
5
10
SCALE IN MILES
National and Insular Capital
Roads
Airport
Salt Pit
Insular Capital
Oil Refineries
Industrial Sites
International Boundary

EXECUTIVE SUMMARY

The activities of the offshore financial sector in the Netherlands Antilles have grown rapidly since the mid-1970's, and as a consequence the contributions of the offshore sector to the economy of the Netherlands Antilles have expanded to the point of being highly significant. These contributions are particularly important to the Island Territory of Curacao, where most of the offshore firms are based.

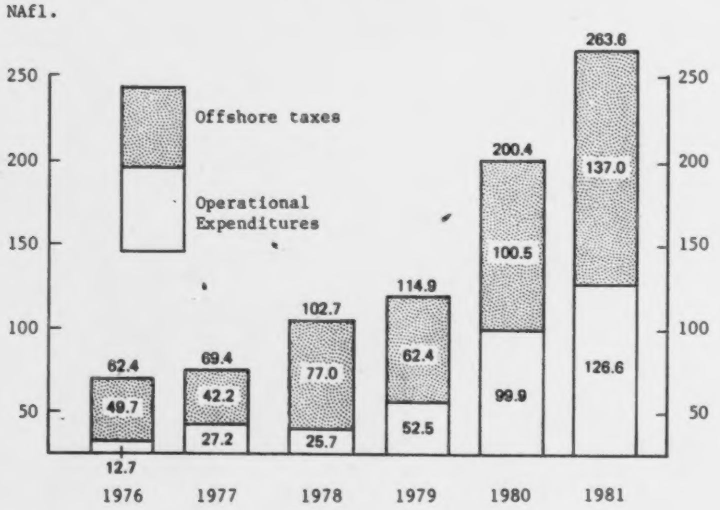
Tax revenues and foreign exchange earnings are the principal benefits the Netherlands Antilles derives from offshore operations. Profit taxes earned from the offshore sector have grown at an average annual rate of over 22 per cent since 1976, rising from NAfl. 50 million ($28 million) in 1976 to NAfl. 137 million ($77 million) in 1981. The offshore sector provided 43 per cent of total profit taxes received by the Netherlands Antilles in 1980, and 61 per cent of total profit taxes received in Curacao. These revenues were sufficient to cover 29 per cent of total current expenditures of the Island Government of Curacao.

GROWTH OF TOTAL OFFSHORE TAX REVENUE
(NAfl. Millions)



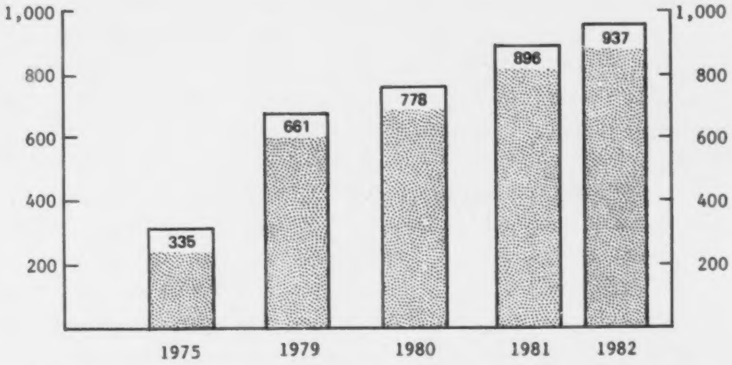
The foreign exchange earnings contributed by the offshore sector, which include the combined inflows for tax remittances and operational expenditures, have grown even more dramatically, by an average rate of 33 per cent annually over the 1976-1981 period. The total foreign exchange earnings from the offshore sector in 1981 amounted to NAfl. 264 million ($147 million), an amount which covered 20 per cent of the merchandise trade deficit in that year. Since nearly everything consumed in the Netherlands Antilles must be imported, a high priority is placed on any economic activity that generates foreign exchange. The offshore sector is now firmly established as one of the four service sector "pillars" earning foreign exchange (the others being oil refining, tourism and transportation services) needed to finance imports. The growth of exchange receipts from offshore activities in comparison with that of the other service sectors has been striking.

FOREIGN EXCHANGE CONTRIBUTION
OF THE OFFSHORE SECTOR
(NAfl. Millions)



Direct employment in the offshore sector, as calculated by an SRI International survey of the offshore firms, has grown roughly threefold since the mid-1970's, to a current level in excess of 1,000 employees. This is particularly important for Curacao, where official estimates place unemployment rates at levels of 20 per cent or more. On the basis of conservative assumptions, it can be estimated that some 4,000 or more workers in the private and public sectors (mainly in Curacao) depend directly or indirectly on the offshore sector for their employment.

EMPLOYMENT GROWTH IN THE OFFSHORE SECTOR



*Survey result totals, rather than total offshore sector employees.

While the direct employment impact of the offshore sector is not as significant as revenue and exchange earnings, the "multiplier effects" of offshore sector operations on other sectors within the economy are considerable. Benefits are obtained directly or indirectly by the local service, supply, construction and tourism industries. Through tax payments, the offshore firms also directly support the programs of and employment in the public sector.

Many of the contributions of the offshore sector are in support of activities around which the Netherlands Antilles seeks to shape its future development. While data deficiencies prohibit strict comparisons of sectoral developments over time, existing information supports the assertion that the international service sector — including offshore finance — has far greater growth potential than other sectors within the Netherlands Antilles economy, such as oil refining and manufacturing, at least in the near term. In view of the economic alternatives open to the Netherlands Antilles, the offshore financial sector and the activities it creates constitute a major source of economic growth.

The natural consequence of a significant decline in offshore transactions would be a sharp fall in exchange and revenue earnings, and an eventual reduction in employment in the Netherlands Antilles. These developments would in turn require forceful measures to reduce the consumption of imports and decrease the public services and employment currently provided by various government entities.

Following a lengthy period of deterioration and stagnation, the Netherlands Antilles economy has in recent years shown clear signs of revival. An almost total dependence on oil sector operations in former years has been replaced gradually by a more diversified set of productive economic activities. The offshore financial sector has played a major role in this evolution and improved outlook, and its contributions are likely to assume even greater importance as current political developments evolve.

I. INTRODUCTION

A. Purpose and Objectives of the Study

This study examines the role and impact of offshore financial activities on the economy of the Netherlands Antilles. Particular attention is given to the island territory of Curacao, from which most of the offshore business is conducted. The viability of the offshore sector is to a major extent dependent on treaty relationships between the Netherlands Antilles and other nations, particularly the United States. The U.S.-Netherlands Antilles Income Tax Convention is currently in the process of renegotiation. This study analyzes the importance of the offshore sector to the Netherlands Antilles, and explores the domestic implications of potential changes in treaty relationships.

The Netherlands Antilles' offshore sector has developed rapidly, as have its economic contributions to local employment, income and tax revenues. The magnitude of these growing activities and contributions, however, has to date largely been a matter of speculation. Quantitative information on the offshore firms' operations has been limited, and the considerable amount of data already collected by various government departments and agencies has never been aggregated for the purpose of studying the offshore community itself. Adding to the problems of data limitations and the absence of systematic analysis of existing information is the fact that international financial transactions are often shrouded in secrecy and a certain degree of mystery, since the actors involved in this highly competitive market understandably seek to limit outside knowledge of their operations.

SRI International has undertaken, on behalf of the Government of the Netherlands Antilles, to analyze the nature and economic impact of the offshore sector. To carry out this task, SRI International has employed a methodology consisting of two substantive components: first, detailed information on activities of the offshore sector itself was collected and examined to determine the direct impact of this sector on the economy;

second, the overall economy of the Netherlands Antilles was studied to assess the relative importance of the offshore sector in comparison with other major sectors of the economy. At all times an emphasis was placed not only on historical developments to date, but also on prospective trends and contributions. The conclusions of this report are based on assessments of the comparative prospects of the various constituent parts of the Netherlands Antilles economy.

In practical terms, the SRI International study has proceeded according to the following research plan. First, macroeconomic analyses of the Netherlands Antilles were collected and examined to provide a consensus overview on developments in and prospects of the economy. The sources of these analyses include the Netherlands Antilles government, the World Bank, the International Monetary Fund (IMF), the United States Department of State, the U.S. Agency for International Development (AID), and a number of private research institutions. In addition, a literature search was conducted on all references listed in the U.S. Library of Congress files on publications relating to the Netherlands Antilles.

The SRI International project team visited Curacao in June to conduct initial interviews with government and private sector officials, to gather and assess existing data and to request additional information. On the basis of this material, SRI International prepared a preliminary report which concluded that a systematic analysis of the offshore sector was feasible and which served as a planning document for this report.

SRI International then designed a survey to be completed by the offshore financial institutions. The objective of the survey, a copy of which is appended to this report, was to generate new, detailed information on the contributions of the offshore sector to local employment, purchases of goods and services, and tax payments. The questionnaires were distributed by two bankers' associations (the Vereniging Offshore Belangen and the Association of Offshore Bankers in the Netherlands Antilles). Upon completion by the individual firms, the questionnaires were collected by the Department of Finance in sealed envelopes (to assure the confidentiality of individual firm data) and were delivered unopened to SRI International. The results of the survey are discussed in this report.

The SRI International project team returned to the Netherlands Antilles in August to collect and review the survey responses, confirm information already received, and carry out an additional round of interviews with officials in the relevant government agencies, in the financial sector and in other prominent sectors of the Netherlands Antilles economy.

During the course of its investigation, the SRI International project team received a high degree of cooperation from representatives of both the Netherlands Antilles government and the private sector. The schedule constraints governing the conduct of the study provided very little time for those questioned to respond to requests for information, much of which was not readily available. Interviews were noteworthy for the candor of respondents to lines of questioning, even those involving sensitive economic or political issues. In sum, SRI International is confident that it received all pertinent information available within the time frame allocated for the analysis. The quantitative and analytical information drawn from a wide variety of sources exhibits a surprising degree of consensus, and any inconsistencies that appeared are minor.

B. The Role of the Offshore Financial Sector

In order to reach conclusions concerning the economic impact of the offshore financial sector to the Netherlands Antilles, a basic understanding of the activities of this sector is necessary. To the casual observer, international financial operations appear to be an arcane web of interaffiliate relationships and intricate legal structures. Indeed, the corporate organization and accounting practices for international activities are in many cases complicated, but the transactions themselves are usually relatively simple.

Offshore financial activities such as those carried out in the Netherlands Antilles consist of financial transactions -- borrowing, lending, and investing -- between two or more entities located outside the jurisdiction of the offshore center. In fact, government policy in the Netherlands Antilles has been designed to ensure that offshore activities remain strictly separated from local financial transactions. The international transactions may or may not physically flow through the offshore center (most do not), but they are recorded in the financial records of institutions based in the offshore center. By definition, the funds involved remain "offshore"; that is, the funds themselves do not affect the economy of the offshore center except through activities associated with managing the transactions.

The principal reason for international banks, firms, and other private investors to utilize offshore financial centers is to take advantage of favorable tax treatment for their transactions as stipulated in tax treaties negotiated between the government of the offshore center and the governments of other nations.

The Netherlands Antilles emerged as an offshore financial center in the mid-1960's with the growth of corporate "finance subsidiaries". Incorporated as wholly-owned subsidiaries of large international firms, these companies were created for the purpose of raising funds from the Eurocurrency or other external capital markets in the form of bond issues, syndicated loans or direct bank loans. Upon being secured, these funds would be on-lent to the parent firm or other related affiliates.

Activities of finance subsidiaries continue to represent the core of the offshore sector in the Netherlands Antilles. However, as international financial transactions grew and became more sophisticated in the 1970's, so also did the range of offshore activities. One important development was the expansion of investment companies, whose purpose was to channel funds into a range of investments, primarily in the United States. In addition, offshore companies have been created to hold ownership shares in foreign companies and real estate enterprises, and to hold rights to patents, royalties, and copyrights. In each case, the viability and attractiveness of these offshore activities depend largely upon provisions in existing tax treaties with other countries, particularly with the Netherlands and the United States.[1]

Historical developments in the treaty relationships of the Netherlands Antilles are detailed in Appendix 1, but the essential benefits derived by the offshore sector can be summarized as follows. Under a provision of the current tax treaty between the United States and the Netherlands Antilles (one purpose of which was to avoid double taxation), affiliates of U.S. companies benefit by an exemption from U.S. withholding tax on the interest paid by the U.S. parent to the Netherlands Antilles subsidiary. Normally, a 30 per cent withholding tax on gross interest payments made from the United States is applied. In on-lending funds, the Netherlands Antilles subsidiaries pay to the Government of the Netherlands Antilles a profit tax of 24-30 per cent (24 per cent on the first NAfl. 100,000, and 30 per cent of any amounts in excess of NAfl. 100,000) on the interest rate margin, rather than the 30 per cent U.S. withholding tax on gross interest payments. (One U.S. dollar equals 1.79 Netherlands Antilles guilders.)

A simple example would be useful to illustrate the benefits of this treatment. (Please keep in mind that the following example relates to only one of the Treaty's provisions, of which there are many). To satisfy the parent firm's requirement for capital, a Netherlands Antilles finance subsidiary borrows $100,000 from the Eurocurrency market at an interest rate of 14 per cent. The subsidiary in turn lends the funds to the parent firm at a rate of 15 per cent, at a one per cent margin over its own borrowing costs. The funds are held for one year before repayment. The parent firm then pays the finance subsidiary $115,000 to settle its principal and interest charges; the subsidiary in turn pays its lenders $114,000 and accrues a net profit of $1,000. Without the existing tax treaty, the finance subsidiary would have a tax liability of $4,500 to the United States -- 30 per cent withholding tax on the $15,000 gross interest charges. (In the real world, under these circumstances the parent firm would opt for borrowing the money directly at 14 per cent, paying interest of $14,000, with the lender liable to a 30 per cent withholding tax of $4,200). Under the provisions of the treaty, however, the finance subsidiary has no tax liability to the United States, but rather is subject to a Netherlands Antilles profit tax of $300 (30 per cent of the net profit of $1,000, assuming that the 30 per cent rate holds for the entire amount). Hence, the consolidated corporation pays a total tax amounting to only 6.7 per cent of what would have been paid in the absence of a tax treaty. In addition, the parent firm may also receive credit against U.S. tax liabilities for tax payments made to the Netherlands Antilles. If the provisions of the tax treaty were not available, then the borrowing costs to the firm would have been raised significantly, perhaps to the point of being prohibitive.

The treaty also extends benefits for a number of other forms of financial transactions. As a result of these and related tax provisions, offshore financial activities carried out in the Netherlands Antilles have expanded considerably throughout the 1970's. Transactions generally fall within the following categories of corporate structures:

- Finance subsidiaries, as previously discussed, are utilized to achieve favorable access to Eurobond markets. While the bulk of this category consists of wholly-owned subsidiaries of U.S. corporations, it also includes subsidiaries of non-U.S. firms;
- Holding companies own 100 per cent of the shares of foreign corporations (primarily in the United States) and receive dividends from those firms at reduced withholding tax rates;
- Investment companies include portfolio companies, mutual funds, and privately-owned family funds which manage a variety of financial investments;
- Real estate companies are established to channel funds into real estate markets (primarily in the United States);
- Royalty companies own the rights to and receive the income from patents and copyrights in both the industrial and artistic fields;
- Offshore trading companies carry out transactions on international sales and purchases of merchandise goods, and in some cases, perform transshipment services;

- Shipping companies are utilized to register vessels in the Netherlands Antilles; and
- Factoring companies finance the operations of companies or retail and wholesale sales through the purchase of accounts receivable.

According to the Netherlands Antilles tax authorities, the offshore financial sector consists of some 25,000 separate companies, 6,000 of which are not yet fully registered. Some 40 per cent of those registered are dormant. What remains is a bewildering number of firms established within a variety of corporate structures and for a wide range of purposes.

Analyzing the economic impact and contributions of even a fraction of the total number of offshore firms incorporated in the Netherlands Antilles would appear impossible. However, the functional operation of the offshore sector is such that the financial activities of almost all these companies are managed by a very limited number of offshore banks and trust companies physically located in the Netherlands Antilles, mostly on Curacao. Private and public sector authorities estimate that the five largest offshore trusts and banks manage and account for approximately 90 per cent of the offshore business, and that the top ten firms account for some 95 per cent of the market. As a result, the information required for conducting an economic impact analysis of the offshore sector can be obtained from a manageable number of companies, either directly or indirectly from the companies' reports to government authorities.

As detailed in sections III and IV of this report, the contributions of the offshore financial sector to the Netherlands Antilles economy can be divided into two principal components: the generation of government revenues and the generation of local economic activity. Data received on income tax assessments and payments is sufficient to provide a basis for analyzing the direct revenue contributions of the offshore sector. Information collected on the employment, local purchases and other economic contributions of the offshore sector is based on the overall operations of the large firms which carry on a variety of financial activities (e.g., servicing finance subsidiaries, managing investment companies, operating real estate companies, etc.). Since the personnel of most of the large banks and trust companies divide their time among several activities, it is impossible for the companies to separate economic contributions into different functional categories. As a result, the assessment of economic impact in this report will be based on the offshore sector as a whole, rather than on its component parts as outlined above.

The following analysis will show that the total effect of the offshore financial sector on the Netherlands Antilles economy is considerable, and that the positive contributions of this sector are significant. These findings are particularly true in view of development alternatives available to the Netherlands Antilles (especially Curacao), and particularly when one looks toward future prospects rather than past performance.

The SRI International analysis concludes that the major contribution of the offshore sector accrues to the Netherlands Antilles in the form of tax revenues and foreign exchange earnings. Profit taxes from offshore financial activities have grown from NAfl. 29.4 million ($16.4 million) in 1973 to as high as NAfl. 137.0 million ($76.5 million) in 1981. In 1980, the offshore sector provided 43 per cent of total profit taxes received by the Netherlands Antilles, and as much as 61 per cent of total profit taxes received in Curacao. Given the large role played by the government in the economy, and given the prospects for alternative sources of revenue in both the Netherlands Antilles as a whole and Curacao in particular, tax receipts from the offshore sector assume an important role. (The figures noted above do not include revenues derived indirectly through wage withholding taxes, stamp taxes, real estate taxes and other indirect taxes collected from the offshore sector).

Profit tax revenues from the offshore sector contribute directly to the external cash flow balance of the Netherlands Antilles, since these funds constitute foreign exchange earnings from overseas firms. The operational expenditures of the offshore companies (paid in the form of representation fees to Netherlands Antilles banks and trusts) bring in an additional and rapidly growing amount of foreign exchange. These expenditures have risen from a net inflow of NAfl. 12.7 million ($7.1

million) in 1976 to NAfl. 126.6 million ($70.7 million) in 1981. When combined, profit tax revenues and operational expenditures provided the Netherlands Antilles with some NAfl. 264 million ($147 million) of foreign exchange in 1981, without which the current account balance would have recorded a considerable deficit rather than the surplus registered.

Beyond tax revenues and foreign exchange earnings, the economic effects of the offshore sector are felt in the form of local employment, income, and purchases. While the figures associated with these contributions are not as dramatic as those noted above, the offshore community constitutes one of the few dynamic sectors within the economy. The multiplier effects of its operations are considerable, with benefits accruing to local service, supply, construction, and tourism industries. The growth of the offshore sector has promoted the development of a sophisticated communications infrastructure and a well-educated, managerial labor pool, both of which are important ingredients in the Netherlands Antilles' long term economic strategy to expand and diversify its international service industries.

In order to assess the relative and absolute importance of the offshore sector, it is first necessary to comprehend the economic milieu within which this sector has developed and now operates. The following section of this report provides a brief overview of Netherlands Antilles economic development and current sectoral strengths and weaknesses.

II. THE OFFSHORE FINANCIAL SECTOR: THE MACROECONOMIC CONTEXT

A. A Historical Perspective

The Netherlands Antilles are made up of two sets of islands in the Caribbean Basin area. The Leeward Islands consist of Aruba, Bonaire and Curacao, and lie some 25 miles north of the coast of Venezuela. The Windward Islands group is located about 500 miles northeast of the Leeward group (approximately 100 miles east of Puerto Rico) and includes Saba, St. Eustatius and the southern portion of St. Maarten (the northern part of which remains within the French overseas department of Guadeloupe).

The total area of the Netherlands Antilles amounts to less than 1,000 square kilometers (about 383 square miles), of which the Leeward Islands account for almost 95 per cent. Of the total Antilles population of about 253,000 (1980), about 90 per cent live in either Aruba (±60,000) or Curacao (±160,000). Most economic activity in the Netherlands Antilles is located on these latter two islands, and so most of the emphasis in this report will be focused on them.

The Antilles were until 1954 a dependent territory of the Netherlands, although they managed their own domestic affairs after 1951. In 1954 this status was formalized with the establishment of the Tripartite Kingdom of the Netherlands (the Netherlands, the Netherlands Antilles and Surinam). Surinam has since become fully independent, and Antillean independence remains an issue of considerable discussion. Currently the Antilles is fully autonomous in internal affairs, but external relations, including defense, continue to be managed by the Netherlands.

Curacao was discovered by a Spanish explorer (Alonzo de Ojeda -- his navigator was Amerigo Vespucci) in 1499, and the Spanish took possession of the Leeward Islands in 1527. The Netherlands gained control of the three islands in 1634, and with the exception of two short periods of British rule (during the Napoleonic Wars) they remained Dutch colonies until 1954. The Windward Islands changed hands on numerous occasions during the

European wars of the 17th and 18th centuries, but have remained under uninterrupted Dutch rule since the beginning of the 19th century.

To understand the nature and activities of the Netherlands Antilles economy (particularly those of Aruba and Curacao), one need only comprehend the basic role of the Antilles as entrepots, or trading centers. Nearly all economic activity is oriented, directly or indirectly, toward servicing international transactions of one kind or another. Entrepot economies are noteworthy for their lack of a natural resource base, their relatively high population density, and their attractiveness as international ports of trade.

Like Hong Kong and Singapore, the Netherlands Antilles clearly fall into the entrepot category. Each possesses excellent harbor facilities and a favorable geographic position to take advantage of international trade routes. Each has limited capacity to provide its people with food and raw materials; the Antilles are particularly disadvantaged since they are not connected to mainland sources of supply. Each has focused historically on international trade (primarily via shipping) and has in recent years become an international financial center. Unlike Hong Kong and Singapore, however, the Netherlands Antilles has not developed a thriving manufacturing sector, for reasons which will be discussed later.

During its early colonial period, the Curacao economy was dominated by plantations, which produced both agricultural products (maize and beans) and cattle, the latter primarily for export. For about a century following the mid-1600's, Curacao acted as a thriving transshipment center for African slaves to Spanish colonies in South America and other islands with labor shortages. The slave trade gradually fell off after 1713, and the last slave ship docked in 1778.[2]

Throughout the 19th century, the people of Curacao subsisted on trade and shipping. The only important export commodity was Panama straw hats, for which even the straw had to be imported. The relatively stagnant condition of the Curacao economy changed radically in 1915, when the Royal Dutch/Shell oil company decided to construct a refinery there to process and ship the crude oil lifted from the Maracaibo region of Venezuela. The establishment and expansion of Shell's activities was based on Curacao's favorable climatic and geographic conditions as well as on considerations of political stability.

The economy of Aruba developed according to a similar direction but slightly different pace than that of Curacao. Aruba was originally used as a base for breeding horses, cattle and goats. The Dutch West India Company, which controlled Aruba, prohibited the migration of whites onto the island. In addition, no African slaves were brought in, and so the Aruban labor pool consisted of indigenous and immigrant indians. The discovery of gold in the early 19th century led to a growing mining and smelting industry, and phosphate mining flourished after 1871. By the time of World War I, deposits of both gold and phosphate had been largely exhausted. The only other major activity supporting the Aruban economy was the cultivation and exportation of aloe, for use in certain pharmaceutical products.

Then, as in Curacao, the relatively sleepy Aruban economy was changed drastically by the advent of the oil industry, in this instance the establishment in 1924 of Lago Oil and Transport Company. Lago became a subsidiary of Standard Oil of New Jersey (later Exxon) in 1932. Lago was initially created as a transshipment station for crude oil brought from Maracaibo, but by 1929 it had completed and put into operation a refinery on Aruba.

The coming of the oil industry marked a watershed in the development of the Netherlands Antilles. Chronic unemployment came to an end overnight. Wage rates rose quickly, and labor was attracted from Europe and from other Caribbean islands.[3] Throughout the middle half of this century, the economic activities (and prosperity) of the Netherlands Antilles have been heavily influenced by the operations of the two oil companies.

The interactions between the growing refining sector and shifts in international shipping patterns had a particularly marked impact on Curacao. Commercial non-tanker shipping in the harbor of Curacao doubled between 1922 and 1929. But the traditional merchant ships no longer dominated the traffic; instead, most of the incoming steamers had the refinery as their destination, and by 1929 tankers accounted for some 80 per cent of the port's traffic. During the Great Depression, Curacao witnessed a remarkable increase in tourist cruises. Many ships no longer viable for regular scheduled services changed over to the cruise business, and the main reason they called at Curacao was the rapid and cheap bunkering they could obtain. By 1939, the peak year for shipping, Curacao received 7,169 steamers, compared to a total of 8,669 steamers received in the Port of New York.[4] In sum, a good portion of Curacao's shipping, trade and tourist activities (which remain to this day) were related integrally to the development of the refining sector.

At the peak of their activities in the early 1950's, Shell and Standard of New Jersey employed over 20,000 people — about one third of the labor force -- and contributed some 40 per cent of Antillean GNP and most of the country's foreign exchange earnings.[5] Pressured by competitive factors arising mainly from the growth of worldwide refining capacity, both companies began in the early 1950s to rationalize and automate their refining operations. As a result, their employment dropped sharply to around 6,300 in 1965 and their contribution to GNP fell to about 20 per cent. The reduction in employment was initially eased by increased emigration, but the rate of unemployment eventually rose to a level of over 15 per cent by 1965. As a result of reduced oil activity, real GNP declined in the early 1960's, which combined with population increases caused a fall in per capita income from nearly $1,100 in 1958 to an estimated $995 in 1967. The standard of living would have declined further had it not been for the large infusions of foreign aid from the Netherlands, initiated in the late 1950's.

The Netherlands Antilles at mid-century was ill prepared to cope with a "post-oil" era:

> Even before the Second World War, a few people on Curacao had asked themselves whether the oil would continue to flow into the island forever. They had then made the first hesitant attempts to diversify industrial activity and thus broaden the economic base, but neither Government nor commerce had wanted to listen. ... Optimists and pessimists answered the question differently but were agreed that the disappearance of oil would be tantamount to an unimaginable catastrophe. In the words of a journalist: "An earthquake of universal devastation would be more humane."[6]

By the end of the 1950's, the decline of the oil refining sector forced the Netherlands Antilles government to seek outside financial aid and to involve itself seriously with plans to diversify the economy.

Economic development projects carried out by both the private and public sectors began to take hold in the latter half of the 1960's, and the downward trend in the economy was reversed. The oil companies undertook a number of large investments aimed at modernizing their facilities. The tourist sector began to expand. Investments in infrastructure were made and financed by foreign assistance, primarily from the Netherlands.

The oil refining industry does, however, remain an important component of the Netherlands Antilles economy, especially in terms of contributions to tax revenues and foreign exchange earnings. However, the relatively rapid rise and decline of the refining sector has had a profound and lasting impact on the society and economy. Wages and living standards were elevated to abnormally high levels when compared to other developing nations, and this factor has proved highly detrimental to efforts to shift the economy into other productive activities such as manufacturing. In fact, the major set of strikes and civil disturbances that erupted on Curacao in 1969 had its origin in the fact that newly created employment opportunities in the late 1960's tended to be in sectors which paid much lower wages than those paid in the refining sector.

Over the course of the 1970's, a number of new economic activities -- all in the service sector -- emerged or grew, thus furthering the process of replacing contributions previously made by the refining sector.

- Crude oil transshipment has developed strongly since the early 1970's. Utilizing the Netherlands Antilles' geographic position and excellent deepwater ports, crude oil transported from Africa and the Middle East in very large crude carriers (VLCCs) is loaded into smaller vessels for transport to U.S. ports which are not equipped to receive large tankers;
- Tourism expanded at a rapid and steady pace since the 1960's, with only a temporary downturn during the recession of 1974 and 1975;
- Ship repair and servicing became a considerable contributor to employment as drydock facilities were completed or improved; and
- The offshore financial sector, which had its roots in the early 1960's, became a growing source of employment, tax revenues, and foreign exchange.

B. The Netherlands Antilles Economy: Sectoral Contributions

Analyzing economic developments in the Netherlands Antilles has always proved difficult for two inter-related reasons. First is the entrepot character of the economy: a very large volume of goods and services flow into and out of the islands in various trade transactions, hence dwarfing strictly local activities. For example, imports and exports of crude oil and petroleum products in 1979 were each at least three times the value of total GNP for the Netherlands Antilles. The related analytical problem has been data availability. Economic missions from international organizations have consistently noted in their reports the problem of data deficiencies, particularly in the areas of national accounts, the labor market and foreign trade. Efforts to overcome many of these deficiencies have recently been undertaken by the Netherlands Antilles authorities, which have to cope not only with conceptual and reporting problems, but also with the fact that many statistical series are collected separately by the various island governments.

With these caveats in mind, the SRI study team has compiled sufficient information to piece together a fairly clear and consistent picture of the Netherlands Antilles economy, particularly as it relates to the contribution of the offshore financial sector.

As can be seen in Table 1, the people of the Netherlands Antilles have achieved comparatively high levels of income and standards of living as a result of oil refining activities, generous levels of foreign assistance, and, more recently, contributions by other international economic activities. Income is fairly evenly distributed, which along with significant government programs have given the Netherlands Antilles a social performance (in terms of literacy, life expectancy, infant mortality, etc.) comparable to those of advanced industrial countries.

Having attained a high level of income relatively early in its development history (compared to other developing countries), the Antillean economy has not, however, shown much progress over the past several decades. The average growth rate of real per capita GNP over the 1970's was less than one per cent, far lower than the average for developed (3.2 per cent) and developing (2.4 per cent) countries. The average rate of inflation over the past decade was 9.3 per cent annually. The historically low rate of inflation rose continuously over the second half of the 1970's to 16 percent in 1980 before falling off to 8.6 per cent in 1981.

1. National Income

When examining the sectoral makeup of an economy, one normally analyzes contributions to domestic product. A breakdown for the Netherlands Antilles is shown in Table 2. This table indicates that the bulk of gross domestic product is generated by industry (primarily oil refining), followed by trade, transportation, the public sector, and then financial and other business services.

Table 1

NETHERLANDS ANTILLES: BASIC DATA

Geography

Leeward Islands:	Aruba, Bonaire, and Curacao (38 miles north of Venezuela)
Windward Islands:	Saba, St. Eustatius, and St. Maarten (500 miles north-east of Leeward Islands)
Area:	993 square kilometers

Population (1980)

Leeward Islands:	236,220 inhabitants
Windward Islands:	17,114 inhabitants
Total	253,334 inhabitants

Average Annual Population Increase (1970-78): 1.3 per cent

Social Indicators (1980)

Crude Birth Rate (per 1000):	18
Crude Death Rate (per 1000):	5
Infant Mortality (per 1000 live births):	25
Access to Piped Water:	over 95 per cent
Access to Electricity:	over 95 per cent
Adult Literacy Rate:	96 per cent
Life Expectancy at Birth:	62 years

Economic Indicators

GNP per capita (1980):	U.S. $4,290
Per Capita GNP (Real) Growth Rate (1970-79 Average):	0.9 per cent
Central Exchange Rate (since end-1971):	U.S. $1 = NAfl. 1.79
Average Rate of Inflation (Consumer Prices, 1970-80):	9.3 per cent

Table 2

CONTRIBUTIONS TO GROSS DOMESTIC PRODUCT (GDP): 1979

	Amount (NAfl.millions)	Percentage of Total
GDP at Market Prices (Total)	3,155	100.0%
contributed by:		
- Agriculture, fishing, mining and industry[1]	1,195	37.9
- Utilities	41	1.3
- Construction	115	3.7
- Wholesale and retail trade	614	19.5
- Tourism (hotels, restaurants, etc.)	139	4.4
- Storage, transport and communications	371	11.8
- Financial and other business services	240	7.6
- Other services	99	3.1
- Public sector	340	10.8

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[1] Industry constitutes nearly all of this category.

Totals may not add due to rounding.

Source: Central Bureau of Statistics, National Income Accounts of the Netherlands Antilles: 1979, May 1981.

The problem with employing this technique is once again the entrepot nature of the economy. Compared with most other economies, the domestic product of the Netherlands Antilles (that which is physically produced on the islands) far exceeds national income, since a large portion of the Antillean domestic product is transferred abroad in the form of net factor payments (profit remittances). The difference can be seen in the following table.

Table 3

NATIONAL INCOME OF THE NETHERLANDS ANTILLES

(NAfl. Millions: 1979)

Gross Domestic Product (Income)[a]	3,155
(minus) Net Factor Payments Abroad[b]	-852
= Gross National Product (Income)[a]	2,303
(minus) Depreciation[a]	-235
= Net National Income[a]	2,068

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[a] Data from government sources.

[b] Derived.

Although no precise data is available to verify the assertion, the Netherlands Antilles authorities assume that the large portion of transfers abroad (net factor payments) are made from profits realized in the industrial sector, from oil refining and from transshipment activities. As a result, the direct contribution of these sectors to national product is less than their contributions to domestic product. This same problem exists for the trade and tourism sector. As a consequence of these conceptual and data anomalies, the SRI team focused on the employment and balance of payments contributions as a more accurate reflection of true benefits to the Netherlands Antilles economy.

2. Employment

The employment figures shown in Table 4 indicate that the public sector is by far the largest employer in the Antilles, accounting for over a quarter of total employment. Within the private sector, the largest shares belong to retail and wholesale trade, industry, and hotels and restaurants. Within these sectors, a major portion of industrial employment is utilized in the oil refining sector: direct employment at the two refineries is currently about 4,000 workers. (By comparison, the oil refineries in the early 1950s employed the equivalent of about 27,000 workers in the current labor market). According to oil company estimates, approximately an equal number of jobs is created indirectly from their activities, about half of which are in contracting companies and would appear in the industrial sector figures. The other portion is spread widely throughout the economy. Many of the positions in the trade sector are employed to service the tourist trade, since the Netherlands Antilles is a major shopping center, primarily for visitors from Venezuela.

Employment in the financial services sector amounted to 5,185 jobs at the end of 1980, or about 6.5 per cent of the total (or 8.8 per cent of private sector employment). As will be shown later in this report, approximately 1,000 of these jobs are directly attributable to the offshore financial sector.

The distribution of employment by sector changes very gradually in any economy; and the offshore financial sector is relatively new to the Netherlands Antilles. While the absolute level of employment in the financial sector is relatively small, it is important to look also at changes in employment over time. Table 5 indicates job creation by sector on Curacao (the center of offshore activities) over the past three years. Over this time period, the public sector created well over half of the new employment opportunities. Most new private sector jobs have been found in the tourism sector (trade and hotels), followed by the financial sector. Nearly all the growth in the latter was caused by increases in offshore business. (Employment in Aruba's financial sector, by comparison, remained constant over the period). In addition, the third largest labor absorbing

Table 4

NETHERLANDS ANTILLES: EMPLOYMENT BY SECTOR
(December 1980)

	Number of Employees	Percentage of Total
Private Sector Employment	58,874	73.5%
Agriculture	275	0.3
Mining	120	0.1
Industry	11,345	14.2
Utilities	1,349	1.7
Construction	6,600	8.2
Retail/Wholesale Trade	14,140	17.7
Hotels and Restaurants	8,795	11.0
Transport and Communication	4,155	5.2
Financial Services	5,185	6.5
Other Services	6,910	8.6
Public Sector Employment	21,230	26.5%
Public Administration	17,425	21.8
Education	3,805	4.7
Total Employment	80,104	100.0%

Source: Interdepartmental Task Force, Netherlands Antilles (Central Bank, Department of Finance, and Department of Economic Affairs)

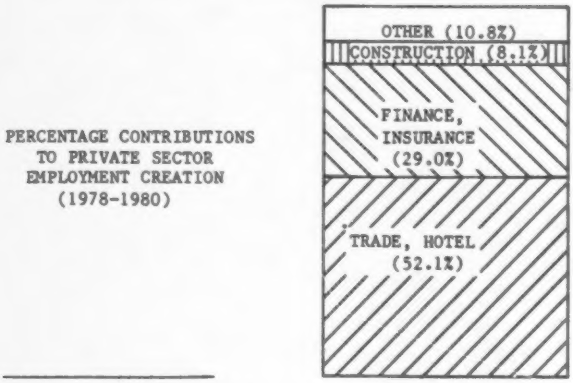
Table 5

EMPLOYMENT CREATION ON CURACAO

Economic Sector	Number of Jobs Created (1978-80)	Percentage of Total New Jobs (%)	Average Annual Growth (%)
Agriculture, Fishing	2	NEG.	1.0
Mining, Industry	21	0.5	0.1
Utilities	23	0.5	2.4
Construction	147	3.3	2.2
Trade, Hotel, etc.	950	21.6	4.2
Transport, Communications	99	2.2	2.0
Finance, Insurance	529	12.0	8.8
Other Services	51	1.2	0.9
Government, Education	2,583	58.6	11.3
Total	4,405	100.0	5.1

CHART 1

PRIVATE SECTOR LABOR ABSORPTION



Source: Department of Finance, Netherlands Antilles sector, construction, was largely employed in building houses and office buildings to house the employees and operations of offshore companies. There was a strong degree of consensus among government and private sector officials that the construction industry would collapse without the business generated by the offshore companies. As will be discussed later, the offshore sector's contribution to other sectors such as tourism, communications and other services has also been significant.

3. Foreign Exchange

The structure of the Netherlands Antilles' balance of payments, as shown in Table 6, indicates even more clearly the contributions of various economic sectors. Very little food and consumer goods are produced on the islands, and hence, nearly everything consumed must be imported. As a result, the Netherlands Antilles must incur continuing and growing deficits in merchandise trade. These deficits must in turn be financed from earnings in services (in the capital balance, net outflows of private capital are basically offset by inflows of foreign assistance from the Netherlands).

As can be seen in Table 6, the services sector is dominated overwhelmingly by four sets of international activities: transportation (shipping operations and oil transshipment, primarily), tourism, oil refining, and offshore finance. Transportation accounts for a large but essentially level amount of foreign exchange earnings. Of the total contribution of NAfl. 329 million for transportation services in 1981, over half (NAfl. 188 million) was accounted for by storage fees, about a third (NAfl. 105 million) by ship maintenance, and the remainder by ship handling, passenger fares, and other services.

The tourism sector earns (according to these accounts) the largest amount of foreign exchange, a level which has been growing rapidly; however, studies have shown that the true net foreign-exchange effect of tourism in the Netherlands Antilles amounts to about 40 per cent of the

Table 6

NETHERLANDS ANTILLES: BALANCE OF PAYMENTS, 1976-81
(Net Cash Flow, Millions of N.A. Guilders)

	1976	1977	1978	1979	1980	1981
Net Merchandise Trade	-708.0	-799.5	-963.0	-1,092.0	-1,347.3	-1,328.4
Net Services, Remittances	689.1	774.9	913.1	1,086.6	1,259.7	1,425.0
Transportation	215.0	293.4	289.7	340.6	380.2	328.8
Tourism	274.4	300.1	412.9	476.7	586.2	664.8
Refining Sector Remittances[1]	288.3	265.2	247.9	298.4	263.2	361.2
Investment Income	-104.7	-101.5	-94.4	-91.8	-98.6	-80.7
Offshore Sector	62.4	69.4	102.7	114.9	200.4	263.6
Offshore taxes	(49.7)	(42.2)	(77.0)	(62.4)	(100.5)	(137.0)
Oper. expenditures	(12.7)	(27.2)	(25.7)	(52.5)	(99.9)	(126.6)
Government, n.i.e.	9.2	8.4	11.4	17.4	16.3	9.4
Private Remittances	-36.6	-45.8	-47.6	-55.5	-65.0	-100.0
Other Services	-18.9	-14.3	-9.5	-14.1	-23.0	-22.1
Current Account	-18.9	-24.6	-49.9	-5.4	-87.6	96.6
Net Capital Transactions	69.8	14.9	-44.4	-5.7	116.2	-20.8
Foreign Assistance[2]	70.1	55.3	66.0	87.9	179.1	108.1
Other Government Capital	-7.3	-13.6	-4.6	-15.1	-27.9	3.1
Private Capital	7.0	-26.8	-105.8	-78.5	-35.0	-132.0
Net Errors and Omissions	11.5	8.2	16.0	23.7	23.6	20.3
Net Change in Reserves[3]	-62.4	1.5	78.3	-12.6	-52.2	-96.1

---

[1] These figures are net of the value of consumption of oil products in Aruba, Bonaire and Curacao.

[2] Includes loans and grants, part of which could be included in the current account.

[3] A minus sign indicates an increase in reserves.

Source: Bank of the Netherlands Antilles (Central Bank) Quarterly Bulletin, 1981, Vol. 9.1-9.2.

gross contribution to the current account. This contribution is far less than that which appears in the official statistics, as shown below:

Table 7

FOREIGN EXCHANGE EFFECT OF TOURISM
(NAfl. Millions)

	1979	1980	1981
Gross Exchange Inflow[a]	569.7	686.8	782.8
Gross Exchange Outflow[a]	93.0	100.6	118.0
Net Contribution[a]	476.7	586.2	664.8
40 Per Cent of Gross Inflow[b]	227.9	274.7	313.1

---

[a] Source: Central Bank.

[b] Derived.

The figures for foreign exchange contributions made by tourism, as shown in balance of payments statistics (the "Net Contribution" line) are approximately twice the levels of what are more likely to be the real contributions (the "40 Per Cent of Gross Inflow" line). The reason for this is the fact that gross outflows related to tourism do not capture many of the hidden (and significant) expenses incurred to support the tourism industry, such as imports of food, energy (for air conditioning and water production), and products sold to tourists. Most of these costs would appear in the merchandise trade accounts which record considerable deficits. Hence, without attempting to quantify the real net earnings of the tourist sector, it is still possible to conclude that they are considerably less than what appears in official accounts.

The balance of payments statistics on the oil refining sector (as shown in Table 6), on the other hand, underestimate the real contribution to foreign exchange. This is because the figures shown are net of the value of consumption of oil products in Aruba, Bonaire and Curacao. Adding these values to arrive at gross remittances would raise the oil refineries' contribution considerably, by some NAfl. 226.5 million in 1980 and NAfl. 275.5 million in 1981.

Table 8

FOREIGN EXCHANGE EFFECT OF OIL REFINING
(NAfl. Millions)

	1979	1980	1981
Net remittances of oil refineries	298.4	263.2	361.2
Local consumption of oil products	169.0	226.5	275.5
Gross remittances of oil refineries	467.4	489.7	636.7

Source: Central Bank Data

Therefore, one could conclude that in rough terms what is over-accounted-for in the tourism sector is basically offset by the under-accounting of contributions by the refining sector. The primary reason for the jump in net refinery sector remittances in 1981 was the fact that one of the oil companies had used up tax credits accrued from prior-year losses and incurred tax liabilities. In future years, remittances at levels closer to (or even less than) historical amounts are anticipated.

The foreign exchange contributions of the offshore financial sector have expanded considerably since the mid-1970's. These contributions fall into two categories: offshore taxes paid to the island governments, and operational expenditures (onshore representation costs paid by firms outside the Netherlands Antilles). As shown in Table 6, the major portion of the total offshore contribution in earlier years was in the form of taxes, and these net inflows have risen rapidly, by an average rate of 22.5 per cent annually over the 1976-81 period. The operational expenditures of these firms have grown even more rapidly, from NAfl. 12.7 million in 1976 to NAfl. 126.6 million in 1981, or an average annual rate of over 58 per cent. These operational expenditures now nearly equal tax revenues from the offshore sector, and most of these funds pass directly into private sector economic activities in the Netherlands Antilles. The combined offshore contributions (taxes plus operational expenditures) to foreign exchange revenues have risen more than fourfold, from NAfl. 62.4 million in 1976 to an amount of NAfl. 263.6 million in 1981, registering an average annual growth rate of 33 per cent.

From Charts 2 and 3 one can observe in conclusion that the offshore financial sector has fully established itself as one of the four service sector "pillars" earning foreign exchange to pay for imported products required for consumption in the Netherlands Antilles. Particularly striking is the degree to which the offshore sector has grown in comparison to the other principal service sectors.

C. The Netherlands Antilles Economy: Sectoral Growth Prospects

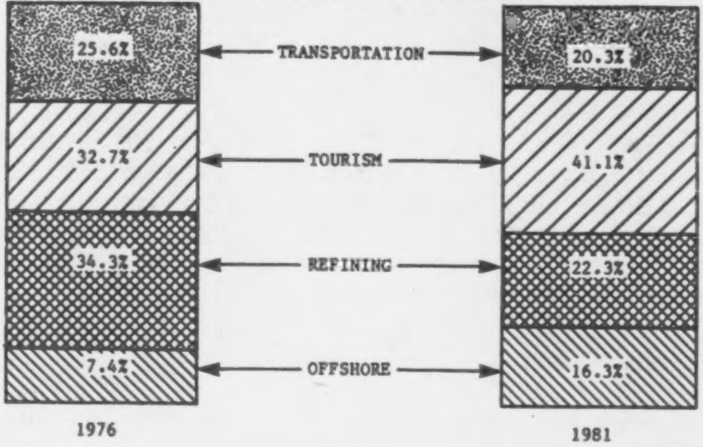
The current structure and future prospects of the Netherlands Antilles economy are, like all other economies, determined largely by their relative endowments of natural resources, labor and capital. On the positive side, the Antilles benefits from a climate that is conducive to tourism, a highly educated labor force, and a geographic/geological configuration that naturally supports shipping activities. The Antilles has also developed a sophisticated infrastructure for carrying out international service transactions.

On the negative side, the Antillean climate is not conducive to agricultural production, and the natural resource base is extremely limited. In addition, labor costs exceed those in other countries in the region significantly, on the order of 40-60 per cent, and for some skill categories are comparable to labor costs in developed countries. The combination of high wages and lack of local materials has resulted in high production costs, hence impeding any efforts to diversify the economy. These basic factors affect the prospects of all sectors within the economy.

CHART 2

NET FOREIGN EXCHANGE REMITTANCES

PERCENTAGE SHARES OF FOUR LARGEST
SERVICE SECTORS FOR 1976 AND 1981



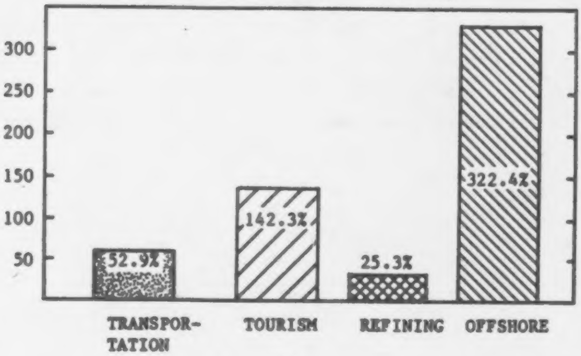
GROWTH IN PERCENTAGE SHARES OF FOUR LARGEST
SERVICE SECTORS BETWEEN 1976 AND 1981

TRANSPORTATION	-20.7%
TOURISM	25.7%
REFINING	-35.0%
OFFSHORE	120.3%

CHART 3

NET FOREIGN EXCHANGE REMITTANCES

TOTAL GROWTH IN REMITTANCES OF
FOUR LARGEST SERVICE (1976-81)



1. Agriculture

Agriculture has for some time played a negligible role in the Netherlands Antilles economy. The quality of the soil is poor, and ground water is so scarce that most water is produced by the expensive process of desalinization. Poor resource endowment and high prevailing wage rates have limited agricultural production to high-priced fresh vegetables and a small amount of livestock (especially goats), primarily for personal consumption. The potential for fishing is also constrained by the fact that the deep waters surrounding the major islands do not contain large schools of fish. The island governments have undertaken efforts to expand agricultural development, through credit and technical assistance, but local and international authorities agree that prospects are limited severely by requirements for high-cost investments in irrigation and soil conservation.

2. Mining

As noted previously, deposits of the only major mineral found on the islands--phosphate--have been largely exhausted by previous mining operations. In recent years, limited limestone mining has been undertaken on Curacao, and solar salt has been produced on Bonaire, but the prospects for additional mineral exploitation of any magnitude are considered negligible. The only possible exception is the possibility of offshore oil deposits. Preliminary seismic surveys indicate the waters surrounding Aruba (and a lesser extent, Curacao) may contain subsea oil deposits. The government has entered into initial discussions with oil companies over possible exploration agreements. The geological structures are promising, but activity in this area has been constrained by current conditions of excess world supply, economic considerations, and political complexities (e.g., island versus central government jurisdictional questions).

3. Manufacturing

The manufacturing sector in the Netherlands Antilles is underdeveloped. Industrial growth has been severely constrained by high wage costs and by the lack of indigenous raw materials. In addition, the very small domestic market limits the scope for import substitution and deters production based on economies of scale. As a result, manufacturing activity is concentrated in consumer goods (soap, beer, etc.) and intermediate goods (e.g., cement) which are naturally protected by high transportation costs.

The experience of the Netherlands Antilles in international trade should theoretically create advantages for the development of an export processing industry. However, efforts in this area have been impeded effectively by high energy, raw material and labor costs. For example, two large, foreign electronic firms with operations in Curacao closed these plants in 1976 and laid off some 1,500 workers; the major reason cited for the closure by the firms was a combination of wage costs and labor disputes. Union activity in Curacao is considerable, although there are differences of opinion over the degree of union strength.

The largest segment within the manufacturing sector is ship repair. The Curacao Drydock Company has one of the largest drydock facilities in the world, and the company can service nearly any form or size of vessel. The drydock company employs about 1,200 full-time, highly-skilled workers and about 400 part-time workers (when in full operation). In the 1970's, the primary source of business for ship repairs was tankers, but by 1980 the tanker business fell off rapidly as a result of excess tanker supply, worldwide recession and reductions in oil demand. By 1981 the drydock company had diversified its business to include cruise ships, tugs, small vessels and a drilling platform. Even this business has declined markedly in 1982 due to deep recession in the shipping market. In addition, according to industry sources, demand for drydock services among Latin American owners may have been reduced by erroneous press reports that Curacao had been used to repair British war ships during the Falkland

Islands crisis. Whatever the cause, depressed demand has placed the jobs of the entire operation in jeopardy, at least for the immediate future.

From the early 1960's through the mid-1970's, the development strategy of the Netherlands Antilles stressed manufacturing and tourism as the two most important sectors for generating employment. In support of this strategy, the government put into place an impressive battery of fiscal incentives (e.g., tax holidays, exemptions from import duties, etc.). The results of these efforts were disappointing, and so since the mid-1970's the government's emphasis has shifted toward service-related activities such as transshipment and offshore financial services.

The policy shift from manufacturing to services was provided reinforcement by the report of the Dutch "Mixed Commission of Experts," entitled Foundation for an Integrated Policy Framework for the Netherlands Antilles in the Eighties. This report detailed the enormous problems confronting the manufacturing sector, and concluded that, "Further expansion of the Netherlands Antilles as an international center in the financial, commercial, tourist, transport, communications and educational fields is possible and desirable."[7] This conclusion fully reflects the current views of Antillean officials.

Despite a nearly universal attitude of pessimism on the prospects for manufacturing, the SRI International study team believes that opportunities in this sector could develop over the long term, particularly involving products requiring large inputs of technology and capital (rather than raw materials) and highly-skilled labor. Such activities could be located in or associated with existing export zones. However, developing manufacturing opportunities would require fundamental changes in policies and attitudes. Labor unions, for example, would have to display a significantly greater degree of restraint. In addition, policies favoring import-substituting industries would have to evolve into export-promotion measures. Current regulations prohibiting manufacturing in free zones, for example, would have to be changed.

4. Transshipment

As previously noted, crude oil transshipment in the Netherlands Antilles has developed rapidly since the mid-1970's. Oil storage facilities have been constructed in Curacao (Shell), Aruba (Lago) and Bonaire (Bopec). However, the contribution of this sector to the Netherlands Antilles economy has remained relatively small. Total employment is estimated at under 400, and until this year, only one of the three transshipment firms has paid taxes (the tax holiday currently enjoyed by another firm apparently ends next year).

According to industry and government officials, the outlook is for oil transshipment activities to continue at roughly current levels. No major expansions are anticipated. In fact, competing schemes (ship-to-ship lightering on the open sea, port expansions or superport projects in the U.S. Gulf Coast area) may erode demand for oil transshipment activities in the Netherlands Antilles.

The other segment of the transshipment sector involves merchandise goods. Products are stored temporarily in the free zones in Aruba and Curacao, and then shipped in small quantities by Latin American importers, who receive a cost advantage due to lower financing costs because of lower prior import deposits. Utilization of the Netherlands Antilles free zones has been heavy, even though nominal taxes are levied (compared to totally tax-free zones in other countries such as Panama).

To expand transshipment activities further, investments have been made to containerize the ports of both Aruba and Curacao; the Aruba terminal is expected to become operational by the middle of 1983. This form of service activity is likely to grow gradually as facilities are improved and as more experience is attained in managing the free zones. However, this sector cannot be considered a leader in growth potential for the economy as a whole, at least not in terms of employment generation.

5. Tourism

Tourism has grown considerably over the past two decades to the point where it is now the leading private sector component of the economy in terms of employment. The tourist trade is concentrated in Aruba, Curacao and St. Maarten, with a smaller number of visitors received in Bonaire. The tourist market is separated into two segments: cruise tourism and stay-over tourism. The cruise segment consists of cruise vessels docking temporarily and discharging their passengers to shop, gamble and utilize local facilities. Curacao is the leading port of call for these ships, receiving some 170,000 passengers in 1980, followed by St. Maarten (105,000 passengers) and Aruba (73,000 passengers). The stay-over tourists patronize the local hotels. The average number of nights stayed declined somewhat in Curacao, from 5.2 nights in 1970 to 4.7 nights in 1980. Stay-over tourism is clearly more important to the hotel and restaurant industry, whereas cruise tourism is of primary interest to retail stores.

As a source of foreign exchange, the tourist sector is second only to oil refining. However, as noted previously, due to large import requirements, the net contribution of the sector to the balance of payments is much smaller, about 40 per cent of gross earnings.

Resort tourism drawing Americans is concentrated in Aruba and St. Maarten, where the relatively longer average stay of tourists has secured high occupancy rates in both islands, generally above 75 percent. Curacao's duty-free retail trade has attracted a rapidly growing number of shopping tourists, primarily from Venezuela, since the mid-1970's. As shown in the following table, the origin of tourists in Curacao has shifted dramatically since 1973, with the U.S. share falling from 48 per cent to only 13 per cent in 1980, and the Venezuelan share rising from 25 per cent to over 50 per cent.

Table 9

ORIGIN OF TOURISTS IN CURACAO (PER CENT SHARE)

Country	1973	1977	1980
U.S.A.	47.9	19.4	13.3
Venezuela	25.4	42.3	50.4
Netherlands	8.8	5.5	5.6
Canada	1.2	1.4	0.9
Other	16.6	31.3	29.8
Total	100.0	100.0	100.0

Source: Curacao Government Tourist Bureau

This shift in the origin of tourists has several important implications. First, while U.S. citizens spend an estimated $120 per day in Curacao during the peak winter season and $100 per day in the summer, the Venezuelan tourists spend about $200 per day in the winter and as much as $300 per day in the summer. Cruise passengers spend an estimated $100 per day in both seasons. (Comparable figures for Aruba are slightly lower: $90 for North Americans, $154 for Venezuelans and $57 for cruise passengers.) As a result of these differences, the Venezuelan market is of critical importance, particularly to Curacao.

The growth of Venezuelan shopper tourism has provided a fillip to storeowners, but it has also resulted in a general neglect of resort facilities and a deterioration of the large hotels in Curacao. Government authorities estimate that to make the present hotels competitive with other Caribbean resorts, investments of $50 million or more would be required. Because of continuing operating deficits in all of the major hotels, the Curacao government was forced to assume ownership of them and continue to run them (with outside management) at deficits in order to maintain the high level of employment in the hotel industry. By contrast, the hotel industries in Aruba and Bonaire have been operated profitably, in spite of the worldwide recession in 1981 and 1982.

A widespread assessment of the prospects for tourism is currently underway in Curacao. In examining the "tourist product"—the package of activities and sensations which collectively form the vacation experience, such as food, recreational facilities, entertainment, local ambiance, etc.—the Curacao Tourist Bureau among others has concluded that "Curacao has a weak product, it is not satisfying its visitors. U.S. visitors are disappointed by shopping, hotels and beaches. . ."[8] Another general complaint is that in terms of government activities, an excessive emphasis is placed on advertising, and few efforts are made to improve the "tourist product" itself.

In terms of future prospects, further expansion of the Venezuelan market (whose citizens are not as concerned as Americans with the "tourist product") is likely. On the other hand, the growth potential for the North American market is limited; the present level of demand may continue, but little growth can be anticipated unless significant government programs and investments are undertaken. Over the near term, given the continuous and high levels of government subsidization of the large hotels, it is unclear how long the stay-over tourist sector can be maintained as currently constituted.

6. Oil Refining

For the first half of this century, petroleum refining overwhelmingly dominated the economies of Aruba and Curacao. As noted previously, the employment and GNP impacts of this sector shrank considerably over the 1955-1965 period as operations were automated. Substantial modernization and investment for treating high-sulpher crude were undertaken in the early 1970's. Since then, however, the volume of refining fell sharply, partly because U.S. energy regulations protected refineries in the United States and the U.S. Virgin Islands (i.e., through the crude oil entitlement program).

As a result of this and other market-related factors, such as a general reduction in demand, refining capacity in the Netherlands Antilles fell from about one million barrels per day in the mid-1970's to about 880,000 barrels per day by the end of 1979. In addition, the refineries have been operating at levels well below capacity; capacity utilization has declined steadily to approximately 50 per cent.

The volume of throughput at the Lago refinery in Aruba has fallen gradually, from about 300,000 barrels per day in 1979 to a current level of about 240,000 barrels per day. Likewise, the Shell refinery in Curacao has reduced throughput volumes continuously over the past few years, to a current level of about 220,000 barrels per day. Officials at both refineries anticipate that current volumes are likely to be maintained for the foreseeable future.

Given this level of activity, the Lago refinery is expected to retain its current labor force of some 1,300 employees. Shell, on the other hand, whose direct employment has already fallen from 3,260 in 1972 to 2,624 in June 1982, is in the process of further reducing its workforce. Early retirement has been offered to about 300 Shell employees, but additional cuts are required.

According to all public and private sector officials, the outlook for the refining industry in the Netherlands Antilles is for a continuation of operations at roughly current levels of activity, with further gradual declines in employment, particularly in Curacao. Therefore, the refining sector cannot be considered a major source of growth for the economy.

7. Offshore Finance

As will be detailed in the following sections of this report, the offshore financial sector has grown considerably over the past two decades, as has its contributions to the economy. Examining the range of possibilities open to the Netherlands Antilles, the international services sector is perhaps the most promising, and the financial portion of this sector constitutes an "engine of growth" for related service activities, such as trade, transshipment, warehousing and insurance.

8. Conclusions

In the preparation of this report, the mission reviews examined, the statistical material studied, and the interviews carried out, when drawn together, paint a consistent picture of the prospects facing the economy of the Netherlands Antilles. The possibilities for agriculture and mining are very limited. Expansion of the manufacturing sector is confronted by serious constraints, but nevertheless should be pursued. The significant role of the oil sector (both refining and transshipment) will continue, but will not grow. Increased activity in the tourist sector is a possibility, particularly on Aruba, Bonaire and St. Maarten, but major changes are required in Curacao even to retain the current level of activity. The warehousing and transshipment operations in the free zones are a possible growth area, but only gradually over time. Finally, the international services sector, led by offshore financial activities, constitute a highly promising source of potential growth for the economy.

III. THE REVENUE CONTRIBUTION OF THE OFFSHORE FINANCIAL SECTOR

The offshore sector provides steady and growing inflows of tax revenues to both the Island Governments and the Central Government of the Netherlands Antilles. The importance of this contribution is compounded by the delicately balanced structure of the fiscal system.

A. The Nature of the Fiscal System

The fiscal system of the Netherlands Antilles is complicated by intergovernmental relations, which divide responsibilities for tax assessment and collection between the Central Government and the Island Governments. All major taxes are levied by the Central Government, but the responsibility for collecting taxes is shared between the Central and Island Governments. The Central Government generally collects indirect taxes (excise taxes, import duties, etc.), while the Island Governments collect direct taxes (income, wage and profit taxes).

Once collected, the taxes are then distributed according to a complex revenue-sharing arrangement. According to the current structure, 25 per cent of the principal amount of income and profit taxes collected by the Island Governments of Aruba and Curacao are transferred to the Central Government, which in turn transfers 50 per cent of the indirect taxes it collects to the Island Governments of Aruba and Curacao. The provisions for revenue sharing do not apply to Bonaire and the Windward Islands, whose governments are entitled to retain all direct and indirect taxes, in addition to receiving large annual transfers from the Central Government.

An earlier, similar revenue-sharing arrangement fell into disarray in the early 1970's. Since direct taxes were rising more rapidly than indirect taxes, the system led to increasing obligations for net transfers from the Governments of Aruba and Curacao to the Central Government. Faced with sharply rising expenditures, and failing to effect adjustments in the system, the Island Government of Curacao withheld all net payments to the Central Government in the 1973-1975 period, and met only a portion of its

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obligations in 1976 and 1977. The Island Government of Aruba followed suit, withholding net transfers in 1975 and 1976, and meeting only partial obligations in 1977. Noncompliance to the arrangement and related problems led to a buildup of cumulative debts by Aruba and Curacao, to totals at year-end 1981 amounting to NAfl. 36 million and NAfl. 168 million respectively.

The revenue-sharing formula was adjusted in favor of the Island Governments in the late 1970's, but continued to encounter problems. Following additional negotiations in 1981, the current system has been in place since March 1982. Officials interviewed suggested that whether or not the current system will be maintained depends in large part upon economic developments affecting tax bases.

B. The Offshore Sector Contribution

The contribution of the offshore financial sector to the taxes received by the Netherlands Antilles (the Central and Island Governments combined) is shown in Table 10. The taxes collected from the offshore sector (shown in parentheses) are a part of profit taxes. In recent years, the offshore taxes have grown from about NAfl. 42 million in 1977 to NAfl. 98 million in 1980. The offshore share of total profit taxes has fluctuated, from a low of 26 per cent in 1977 to as much as 43 per cent in 1980. The offshore sector's share of total tax receipts ranged from 9 per cent in 1977 to over 14 per cent in 1980. In 1981, taxes received from the offshore sector rose by nearly 40 per cent over the previous year, to a total of NAfl. 137 million. (Comparable figures for total tax recipts are currently unavailable.)

The importance of the revenue generated from offshore financial activities is much more pronounced with respect to the Island Government of Curacao, as indicated in Table 11, which breaks down tax receipts by area for the year 1980. The regional distribution of offshore tax revenue is unavailable, but other sources of information (as will be discussed below) confirm that all but a very small fraction of offshore taxes accrue to Curacao. Thus, of the total profit tax revenue of NAfl. 162 million

Table 10

TOTAL TAX RECEIPTS IN THE NETHERLANDS ANTILLES[1]

(NAfl. millions)

	1977	1978	1979	1980
Taxes On Income And Profits	329.7	377.1	388.4	489.5
Income Tax	47.2	50.4	45.9	48.4
Wage Tax	123.4	127.7	145.3	212.1
Profit Tax (Total)	159.1	199.0	197.2	229.0
(From Offshore Sector)	(41.8)	(77.0)	(62.4)	(98.4)
Property Taxes	27.2	28.7	31.6	36.8
Excise Taxes	40.5	43.3	54.2	66.1
Important Duties and Exchange Commissions	57.3	68.2	79.8	84.0
Other Taxes	9.8	11.8	9.3	7.5
Total Tax Receipts	464.5	529.1	563.3	683.9

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[1] Central and Island Governments

Source: Bank of the Netherlands Antilles (Central Bank), *Quarterly Bulletin*, Vol. 8.4, 1980.

Table 11

TAX RECEIPTS, BY AREA: 1980

	Central Government	Curacao	Aruba	Bonaire and Windward Islands
Taxes On Income and Profit	---	340.3	124.2	25.0
Income Tax	---	33.4	11.1	3.9
Wage Tax	---	144.6	53.7	13.8
Profit Tax	---	162.3	59.4	7.3
Property Taxes	3.6	31.3	1.8	0.1
Excise Taxes	42.7	9.1	10.6	3.7
Import Duties and Exchange Commissions	84.0	---	---	---
Other Taxes	7.5	---	---	---
Total Tax Receipts	137.8	380.7	136.6	28.8

Source: Bank of the Netherlands Antilles (Central Bank), *Quarterly Bulletin*, Vol. 8.4, 1980.

received by the Island Government of Curacao in 1980, about 60 per cent was paid by the offshore sector. The offshore sector provided about one quarter of all tax revenues received by Curacao in 1980.

Data obtained from the Office of the Director and Inspector of Taxes in Curacao confirm the magnitudes of taxes received by the Island Government of Curacao as a result of offshore financial activities. These figures, shown in Table 12, differ slightly from those discussed above in several respects. First, the data in Table 12 are based on tax assessments, whereas the figures in Tables 10 and 11 are based on actual tax payments. There is often a lag in payment after tax assessments have been made. Individual firms may also spread out tax payments over time, or reduce actual payments if they are able to apply prior-year losses against current income. These and other factors, such as previous problems in payment collection procedures, are likely to account for the tendency for assessments to exceed receipts in any given year. On the other hand, the assessments shown in Table 12 do not include data for the few offshore firms located on Aruba. Finally, there are some differences in classification, i.e., what is considered an offshore financial firm. In spite of these inconsistencies, however, the two sets of revenue streams track each other over time. Total tax assessments over the 1977-1980 period amounted to NAfl. 315 million, compared to total recorded receipts of NAfl. 280 million, resulting in a ratio (about 88 per cent) not inconsistent with the experience of most nations. The United States, for example, has a relatively efficient tax collection system. According to U.S. government sources, about 90 per cent of total corporate taxes assessed are eventually received.

The figures shown in Table 12 are important as a basis for several conclusions. First, the offshore sector comprises a steadily growing source of revenue beyond 1980. Continued growth is confirmed by assessments of NAfl. 147 million in 1981, and unofficial estimates of some NAfl. 114 million in tax assessments for the January-August period alone in 1982. Second, since these figures do not include assessments of firms located in Aruba, and since only a minimal amount of profit tax is collected in Bonaire and the Windward Islands (as shown in Table 11), one

Table 12

TAX ASSESSMENTS ON OFFSHORE COMPANIES[1]

(NAfl. millions)

Income Category	1975	1976	1977	1978	1979	1980	1981
I. Activities [illegible]ectly Related To The U. [illegible] Treaty							
Interest/Royalties	19.9	22.8	22.7	30.8	32.0	32.5	68.0
Dividends	2.9	3.9	4.0	3.7	3.6	6.2	8.0
Total	22.8	26.7	26.8	34.5	35.7	38.7	76.0
II. Activities Partially Related To The U.S. Treaty							
Interest/Royalties/Dividends	20.2	28.9	30.1	42.5	48.2	51.0	65.9
III. Shipping Companies	3.7	2.0	1.5	1.6	1.0	0.6	1.7
IV. Offshore Trading Companies	0.3	0.2	0.4	1.1	1.3	0.4	3.5
Total Revenues (Assessments)	47.1	57.8	58.7	79.7	86.2	90.6	147.0

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[1] All islands except Aruba

Totals may not add due to rounding

Source: Office of the Director and Inspector of Taxes can conclude that the overwhelming share of taxes assessed are collected by the Island Government of Curacao.

Finally, the data on Table 12 provides an indication of the importance of the tax treaty relationship with the United States. Over the past few years, approximately one half of total offshore assessments were made on activities directly related to the U.S. treaty--that is, taxes on the interest, royalties or dividends received by affiliates of U.S. firms (or trust companies on their behalf). These assessments are shown under category I. In addition, tax authorities estimate that approximately 30 per cent of the assessments listed under category II are made on activities benefiting from provisions of the current tax treaty with the United States. Therefore, on the basis of this estimate, one can conclude that approximately 60-65 per cent of total offshore taxes assessed are made on financial activities related to the U.S.-Netherlands Antilles Tax Treaty.

The magnitude of tax revenue involved as well as the importance of the U.S. Treaty are again confirmed by another source of information, a survey carried out among the major offshore firms with the cooperation of the Netherlands Antilles tax authorities. While the survey results are not strictly comparable to official tax figures, due to differences in reporting procedures and definitions, the two sets of data are broadly consistent.

The survey compiled data on 1979 revenues from the offshore sector, totalling some NAfl. 99 million. Of this total, 64 per cent constituted revenues from U.S. investments, a share which is of the same order of magnitude as that estimated by the tax authorities. Of the total revenue generated from U.S. investments, about three-quarters was earned from finance subsidiaries, about 15 per cent from portfolio companies, and the remainder from real estate, holding, royalty and other offshore companies. Of the total revenues from finance subsidiary activities, 90 per cent of the subsidiaries were owned by U.S. firms.

These separately generated sets of data together confirm the rising importance of tax revenues derived from the offshore financial sector. The dramatic growth in revenue recorded over the past two years can be explained in part by prevailing conditions in international capital and credit markets. Due to relatively high U.S. interest rates, loan terms on funds raised outside the United States have been more favorable than those on domestic loans. This has encouraged American firms to finance their domestic operations with funds borrowed by their foreign affiliates. As a partial result, the amount of funds transferred from foreign affiliates to U.S. parent firms in 1981 exceeded those flowing from parent companies to foreign affiliates for the first time on an annual basis since 1944.[9] A major proportion of intercompany loans to U.S. parent firms -- according to private estimates as much as 90-95 per cent -- flow though Netherlands Antilles subsidiaries. The increases in this form of financing translate directly into Netherlands Antilles revenue.

Changes in market conditions have in the past caused swings in the amount of business transacted by Netherlands Antilles subsidiaries, and similar changes will take place in the future, but the growth of offshore activities (and the tax revenue generated from them) has been steady over time. This growth is particularly important in view of other actual and potential sources of revenue.

The only other major private sector contributor to taxes is the oil refining sector. The two oil companies are required to pay minimum taxes (a combined total of about NAfl. 60 million), and only occasionally have posted profitable returns. Revenues from the Aruban refinery have exceeded the minimum tax levels over the past two years, but are expected to return to the minimum levels. The Curacao refinery has in recent years only paid minimum taxes, and is expected to continue on a similar basis in the foreseeable future. The hotel industry on Aruba has been marginally profitable, but some hotels still benefit from tax holiday provisions and hence do not pay significant amounts of taxes. The losses incurred in hotels in Curacao, coupled with fees paid to outside hotel management companies, have resulted in this sector being a net drain on the Island Government budget. Finally, the lack of growth in manufacturing has effectively ruled out this sector as a major source of government profit taxes throughout the Netherlands Antilles.

With respect to other forms of revenue, income and wage taxes (which combined represent the equivalent of the U.S. personal income tax) together exceed total profit taxes. Since these taxes are based on the incomes of employees and other individuals throughout the economy, they are dependent on general rises in personal income. Excise taxes and import duties have grown gradually, but only as a function of increases in consumption. In addition, economic missions from international organizations have suggested that the Netherlands Antilles should reduce the level of import tariffs, in order to reduce inefficiencies caused by import substitution policies.

Curacao has recently suffered the loss of a significant source of property tax revenue. Beginning in 1977, the Curacao Government introduced tank taxes (levies on storage tanks) and Bullenbaai taxes (levies on the use of waters and land surrounding the Bullenbaai Bay). By 1980, these property taxes brought in NAfl. 26.4 million, or 84 per cent of total property taxes collected in Curacao. In March 1981, the Court of Justice struck down these taxes, thereby removing them as sources of government revenue.

A review of potential sources of government revenue for the immediate future indicates a growing dependence on wage taxes and profit taxes from the offshore sector. Further increases in wage taxes in turn will depend on general growth throughout the economy, and as noted previously, the growth prospects for most sectors must be considered modest. The expansion of revenues from the offshore financial sector, under prevailing tax provisions, will vary as a function of the level of activity carried out by the offshore firms.

While the revenues received by the Central and Island Governments have increased at a steady pace over the past few years, they have been more that offset by rises in government expenditures. In past years, the relatively small growth in employment opportunities in the private sector was to a certain degree compensated for by rapid increases in public sector employment, which in turn raised current government expenditures. Attempts to implement corrective measures to contain the growth of the public sector were initiated in the late 1970's (e.g., a hiring freeze by the Central Government), but these have been impeded by both structural factors (e.g., wage indexation) and political pressures for maintaining government services. In addition, officials from the public and private sectors alike have been candid in acknowledging both that there is a great deal of room for improvement in the efficiency of government operations, and that the public sector sustains a certain degree of "hidden unemployment" by maintaining government employment roles in the absence of private sector opportunities.

Despite efforts to reduce government expenditures, the consolidated government budget of the Netherlands Antilles (the Central Government plus the Island Governments of Aruba and Curacao) deteriorated throughout the late 1970's. The combined cash deficit rose from NAfl. 52 million in 1977 to NAfl. 80 million in 1979. Since the Island Governments of Aruba and Curacao were both faced with their own deficits, they withheld payments due to the Central Government under the terms of the revenue-sharing arrangement. In addition, requirements for revenue transfers from the Central Government to Bonaire and the Windward Islands continued to grow. Consequently, the Central Government tended to bear the major burden of revenue shortfalls. The Central Government has financed its budget deficits through a combination of domestic and foreign borrowing and monetary financing (primarily through the issuance of treasury paper and through advances drawn from the Central Bank). By the end of 1980, the total public debt, including that of the Island Governments, amounted to NAfl. 654 million, of which some NAfl. 98 million was domestically held and the remaining NAfl. 556 million was external debt, mostly owed to the Netherlands.

In 1980 and 1981, as shown in Table 13, the deterioration in the consolidated government budgets was reversed. Large deficits continued to be incurred by the Central Government, but revenues to the Island Governments expanded sharply, hence turning budget deficits into surpluses. The revenue growth was a result of rises in wage taxes in both Aruba and

Table 13

BUDGETS OF THE CENTRAL GOVERNMENT AND THE ISLAND GOVERNMENTS OF ARUBA AND CURACAO

(NAfl. millions)

	Central Government and Island Governments of Aruba and Curacao combined				Central Government				Aruba				Curacao			
	1979[1]	1980[1]	1981[2]	1982[2]	1979[1]	1980[1]	1981[1]	1982[2]	1979[1]	1980[1]	1981[2]	1982[2]	1979[1]	1980[1]	1981[2]	1982[2]
Current expenditures[1]	683.3	702.7	863.5	970.2	231.8	251.2	301.7	347.3	124.5	141.3	160.8	178.9	327.0	352.0	401.0	444.0
of which transfers to Bonaire and the Windward Islands	12.1	20.7	16.7	23.0	12.1	20.7	16.7	23.0	—	—	—	—	—	—	—	—
Current revenue	628.9	746.9	932.9	1,016.5	182.9	201.3	219.5	284.5	127.0	149.9	250.3	246.3	319.0	395.7	463.1	485.7
Balance (deficit -)	-54.5	2.4	69.4	46.3	-48.9	-49.9	-82.2	-62.8	2.5	8.6	89.5	67.4	-8.0	43.7	62.1	41.7
Revenue sharing transfers (net)	—	—	—	—	17.4	16.7	30.0	53.7	-7.2	-4.7	—	-15.8	-1.9	—	-10.0	-46.4
Current account balance	-46.1	14.4	89.4	37.8	-31.5	-33.2	-52.2	-9.1	-4.7	3.9	89.5	51.6	-9.9	43.7	52.1	-4.7
Other net expenditures (-)	-34.1	-34.8	-33.0	-34.2	-19.7	-16.0	-17.8	-14.2	-12.4	-8.8	-5.2	-10.0	-2.0	-10.0	-10.0	-10.0
Overall cash deficit (-) or surplus	-80.2	-21.1	56.4	3.6	-51.2	-49.2	-70.0	-23.3	-17.1	-4.9	84.3	41.6	-11.9	33.7	42.1	-14.7

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1 Actual

2 Estimated

Source: Department of Finance

Curacao, by higher taxes paid by the oil refinery in Aruba, and by increases in offshore sector revenues in Curacao.

According to Central Bank figures, revenues generated by the offshore financial sector rose by approximately NAfl. 75 million between 1979 and 1981. This increase accounted for over one half of the NAfl. 136 million swing of the consolidated Netherlands Antilles budget, from a deficit of NAfl. 80 million in 1979 to a surplus of NAfl. 56 million in 1981. The offshore sector is of even greater importance to the Island Government of Curacao: if one assumes that almost all of the offshore sector revenues accrue to Curacao, then the increase in offshore revenues accounted for more than one half of Curacao's total increase in current government revenues between 1979 and 1981, and more than accounts for the NAfl. 54 million swing from a cash deficit to a cash surplus over the same period.

IV. THE ECONOMIC CONTRIBUTION OF OFFSHORE FINANCIAL SECTOR ACTIVITY

The basic objective of this study is to determine the impact of the offshore financial sector on the economy of the Netherland Antilles. The principal contributions of this sector, as discussed previously, are made in the form of foreign exchange earnings for the economy as a whole, and profit tax revenues for the government. These contributions represent, in effect, the end products of a wide range of business operations carried out within the firms of the offshore sector, and are documented in official government statistics. They do not, however, capture the economic effects or contributions of the business operations themselves.

The impact of any given form of economic activity can be divided into a direct component and an indirect component. The direct contribution consists of the employment and income generated by the activity itself. The indirect contribution is often termed the "ripple effect" or "multiplier effect". It consists of additional employment and income, not directly associated with the specific economic activity, but rather created either to support the activity or as a result of the circulation of funds initially earned by the activity.

Until now, an extremely limited amount of information has been available on which to base judgements of even the direct, much less the indirect, economic contributions of the offshore sector. Faced with a lack of hard data and little more than hearsay assessments, economists have naturally dismissed the contributions (other than foreign exchange and revenue earnings) as negligible. For example, a World Bank economic mission concluded that:

> [The offshore financial institutions'] . . . contribution to output and employment growth has been small as their staff consists mainly of highly qualified expatriates. Very few local purchases are made.[10]

To test this assertion, as well as claims that might exaggerate the economic contributions of the offshore sector, the SRI International team designed and carried out a survey of the offshore firms operating in the Netherlands Antilles. The survey, a copy of which appears at the end of this report, was intended to generate detailed data on the employment and local purchases of the offshore firms.

Twenty-nine completed questionnaires were received. In a number of instances, individual responses included data for the consolidated operations of several closely affiliated firms. The sample size in no way corresponds to the total number of offshore financial companies incorporated in the Netherlands Antilles. But it must be remembered that the transactions of the overwhelming majority of these companies are managed by a small number of trust companies and banks, the largest ten of which are estimated to account for as much as 95 per cent of the volume of transactions. The sample does include all of the largest trusts, banks and notary firms that service the offshore transactions. However, since the sample does not constitute the universe of firms physically operating in the Netherlands Antilles, this section will include estimates on the total size and impact of the offshore sector, in addition to presenting the survey results themselves.

Upon examination of the survey results, the SRI International team concluded that in nearly all cases the questionnaires were filled out accurately and completely. In a small number of instances, individual cells of information were left blank, presumably because of a lack of data, and in several others problems arose over the interpretation of a given question. In order to meet the schedule required for completion of this study, there was limited time to contact respondents, who had filled out the questionnaires on very short notice, to clarify possible inconsistencies. Therefore, the SRI team has made several adjustments in the data, all of which are duly noted and all of which are minor. In no instance did the SRI team feel that any information was withheld purposely. Therefore, the following data is considered to present a reasonably accurate picture of the impact of the offshore sector.

A. Employment

A total of 937 individuals are currently employed by the offshore firms responding to the survey. Of that number, 922 individuals are employed full-time and 15 part-time. The total figure corresponds closely to general estimates of approximately 1,000 people being employed directly by the offshore firms.

Attempting to expand the survey figures to take into account employment in firms that did not receive or respond to the questionnaires in order to arrive at total employment in the offshore sector is extremely difficult. However, rough orders of magnitude can be estimated through two techniques. First, an examination of several lists of firms which are presumed to have operations physically located in the Netherlands Antilles indicates the presence of approximately 60 firms that did not submit questionnaires. These firms, assumed to be quite small, are primarily corporate finance subsidiaries not domiciled with the local trust companies and banks. If on average each of these companies employs five people--the average of the smallest one-third of firms responding to the questionnaire--then one can infer that an additional 300 are employed in the offshore sector beyond those accounted for in the survey.

A second estimate was obtained by examining data on employment by firm, provided by the Curacao tax authorities. When the employees of companies which had responded to the questionnaire were taken into account, some 450 employees remained. This group includes employees of the large local offices of the international accounting firms which were not included in the survey.

On the basis of these calculations, one can conclude that a minimum of 1,000 workers are employed by the offshore sector in the Netherlands Antilles, and it is more likely that the actual total falls into the range of 1,300 to 1,400 employees.

Some firms, primarily full service banks, engage in both local and offshore business, and it is often difficult to allocate employee time and expenses assigned to each. Therefore, the respondents were asked to estimate the percentage of their overall business activities that are related to offshore transactions, and the percentage allocated to local transactions. Given the wide variance in the size of firms, it was necessary to weight these responses according to the number of employees in each firm. Accordingly, the results show that approximately 86 per cent of the business of these firms (weighted by number of employees) is allocated to offshore activities, and the remaining 14 per cent to local transactions. Applying these shares to the total number of 937 employees in the offshore sector results in a total of about 806 "offshore business" employees and about 131 "local business" employees. If the total size of the offshore sector is more nearly 1,300 to 1,400 employees, then the actual number of employees engaged in offshore transactions is more likely to fall into the range of 1,100 to 1,200 employees.

In order to determine the degree to which local employment opportunities are generated (as opposed to expatriate employment opportunities), the firms were asked to divide their employees into two categories--citizens of the Netherlands Antilles, and citizens of other countries (including the Netherlands). Of the full-time employees, 792 were Netherlands Antilles nationals and 130 were foreign nationals. Assuming that all part-time employees are Antillean, the total employment for citizens of the Netherlands Antilles is 807, or some 86 per cent of the total. This share tends to refute the World Bank's conclusion that the staff of the offshore sector consists mainly of expatriates. However, officials within the offshore sector acknowledged the point that expatriates usually do fill the higher level positions within each firm.

The questionnaire then asked the offshore firms to give a breakdown of their current employees according to a number of job classifications. The results are as follows:

Table 14

FUNCTIONAL DISTRIBUTION OF OFFSHORE EMPLOYEES

Job Classification	Number of Employees
Executives (Directors, Officers)	67
Division chiefs	41
Account officers	25
Attorneys	32
Accountants	80
Clerks	343
Secretaries	188
Computer programmers, operators	40
Office maintenance personnel	58
Messenger	45
Other	18
Total	937

The breakdown indicates that the offshore firms employ individuals in a fairly wide range of skill categories, many of which are necessary for the development of a sophisticated service sector. While the absolute numbers are far from dramatic when compared to a large country, they are relatively significant for an economy as small as that of the Netherlands Antilles. Total employment on Curacao, for example, is currently estimated to be about 47,000.

To determine the extent to which employment opportunities in the offshore sector have grown over time, the firms were asked to list their number of employees over the past few years. Several companies commenced operations during the period covered. One firm was unable to provide historical data, and so the employment growth results were adjusted (according to the average growth of other companies). Both the actual numbers received and the adjusted figures are shown below.

Table 15

GROWTH IN OFFSHORE SECTOR EMPLOYMENT
(total number of employees)

	1975	1979	1980	1981	1982
Actual Survey Data	319	629	741	896	937
Adjusted Data	335	661	778	896	937

These figures confirm that employment in the offshore sector has grown consistently since the mid-1970's, by an average rate of about 16 per cent annually. As shown below, most of these employment opportunities have been opened up on Curacao, where according to official statistics unemployment rates have grown to, and remained at, about 20 per cent. Alternative private sector employment opportunities have been very limited.

While unemployment is not a major concern on Aruba or Bonaire, it is considered the most pressing economic and social problem being faced on Curacao. Slackening demand in the tourist, oil refining and manufacturing sectors has exacerbated the unemployment problem in Curacao recently, a fact which is confirmed by the rising number of applications for dismissals presented to government authorities.

In order to arrive at an estimate of the geographic distribution of offshore activities within the various islands of the Netherlands Antilles, the firms were asked to provide the percentage distribution of their employees (engaged in offshore activities rather than in local business) in each of the island territories. The results were striking.

Table 16

GEOGRAPHIC DISTRIBUTION OF OFFSHORE EMPLOYEES

	Aruba	Bonaire	Curacao	St. Maarten	Other	Total
Percentage of employees	2	--*	97	1	--*	100

*Negligible

As can be seen, nearly all employees engaged in offshore activities are stationed in Curacao. This does not, however, take into account firms located outside of Curacao which did not receive or respond to the questionnaire.

As the final question in the employment section of the questionnaire, the firms were asked to provide figures for the total amount of salaries and benefits paid to their employees in 1981. The total compensation amounted to NAfl. 31.9 million, although several firms did not include payments for certain fringe benefits such as retirement funds. This amounts to an average compensation of about NAfl. 34,000 ($19,000) per employee, well above the average for all other sectors, with the possible exception of oil refining. These funds circulate widely throughout the economy, as the offshore sector employees purchase food, consumer goods and housing.

According to records filed with the Curacao tax authorities, the salaries alone (excluding benefits) of all offshore companies amounted to NAfl. 70 million in 1981. While these figures include firms outside of the offshore financial sector itself (shipping companies, transshipment companies, etc.), they also incorporate data from accounting and other service sector firms which are dependent on the offshore financial sector for their viability. With this in mind, as well as the fact that numerous small finance companies did not answer the questionnaire, it is not unreasonable to conclude that employee compensation on the order of magnitude of between NAfl. 40 million and NAfl. 50 million is directly attributable to the activities of the offshore financial sector.

B. Local Expenditures

To capture some of the "multiplier effects" of the offshore sector throughout the rest of the Netherlands Antilles economy, the firms surveyed were asked to provide figures on expenses in several categories.

One must keep several caveats in mind when examining these figures. First, several firms did not include information for 1980, and so the totals for that year are slightly less than the actual expenses of the companies surveyed. Second, the questionnaire included a line for "income taxes". The total amounted to understandably high figures of NAfl. 48 million for 1980 and NAfl. 71 million for 1981, thereby dwarfing all other local expenditures. However, several of the large firms did not include income taxes paid on behalf of their clients, which are significant. Therefore, the income tax figures used in this study, as discussed previously, are drawn from official statistics rather than from the questionnaire.

The survey results for local expenditures by the offshore companies, totalling NAfl. 28 million in 1980 and NAfl. 33 million in 1981, confirm the conclusion that local purchases of the offshore sector are far less important generators of local economic activity than are the salaries and taxes paid by the offshore companies. This is particularly true in view of the fact that a major portion of local expenses are fees to notaries (over 25 per cent of the total). Since the major notary firms are themselves included in the survey, the spillover employment and income effects of their operations are captured within the survey itself.

As one might expect, the operations of this financial sector do not require large inputs of outside goods and services when compared to other forms of economic activity such as manufacturing. Most of the value added of the finance industry is generated from within.

This conclusion must, however, be qualified in several respects. First, while the local expense figures are not large by international standards, they are important to an economy the size of the Netherlands

Table 17

LOCAL EXPENDITURES OF OFFSHORE FIRMS
(NAfl. thousands)

	1980	1981
Plant and equipment	2,765	3,958
Utilities: Total	3,551	4,826
Electricity	683	984
Telephone/telex	2,482	3,386
Water	82	119
Other	303	337
Office supplies	2,646	3,236
Rent on property	902	1,675
Fees: Total	12,796	13,506
Notaries	7,889	8,348
Accountants	2,203	2,756
Legal services	227	254
Other	2,478	2,148
Local taxes: Total	4,707	5,475
Salary withholding tax	4,197	4,860
Real estate tax	6	6
Other taxes	503	609
International travel via ALM airlines	215	288
Total Local Expenses	27,583	32,964

Totals may not add due to rounding.

Antilles. Second, nearly all of these expenses are paid ultimately by funds generated from outside sources, and thereby represent "export earnings" in the broad sense of the term. Finally, the offshore sector extends key support to a number of important sectors within the economy. Representatives of the private sector on Curacao (other than the offshore sector) were unanimous in their opinion that the construction industry is being maintained almost exclusively by new housing and office structures built for the offshore financial sector or its employees. Local retailers depend on the offshore firms for orders of office supplies and furniture. In addition, the development of advanced communications facilities were attributed largely to the rising demand created by the offshore sector, and the expansion of these and other services have encouraged international firms such as trading companies to locate on Curacao. Given the fixed-cost nature of communications, the cost of these services would rise considerably in the absence of the offshore sector.

The offshore financial sector lends support to the important tourist industry on Curacao in a number of ways. Through their indirect and direct tax payments, these firms extend indirect assistance, since a portion of these funds are used to subsidize the major hotels. The offshore firms also provide approximately 85 per cent of the funds in the budget of the Curacao Chamber of Commerce, and about one half of the Chamber's budget is used for promoting tourism. Finally, the offshore firms themselves generate business for the local hotels and restaurants, since a large number of individuals travel to Curacao to carry out financial transactions. The firms surveyed were asked to estimate the number of foreign visitors that come to the Netherlands Antilles for the purpose of conducting business with them, and the average length of stay. These estimates are highly speculative and not based on any formal records. The results, however, were an annual number of 3,139 visitors, with an average length of stay per visit of 2.8 days. This computes into about 8,790 visitor-days per year. Assuming that each visitor spends about the same as the average tourist from North America, $120 per day (with slightly more on hotel rooms and restaurants, and slightly less on shopping), then the visitors to the offshore firms bring in approximately NAfl. 1 million in business to the tourist industry.

C. Support of the Public Sector

By far the largest economic multiplier effect created from the activities of the offshore financial sector is felt not through the direct purchases of the offshore firms, but rather through the revenues the offshore firms provide for the government budget. The magnitude of this contribution is illustrated by working through the following calculation. The total profits taxes paid by the offshore sector in 1980 amounted to about NAfl. 100 million. Added to this is a further NAfl. 5 million or so in taxes collected indirectly from the sector (primarily through wage withholding taxes). Assuming that all of these taxes accrue to the Island Government of Curacao, then the NAfl. 105 million in revenues generated from the offshore sector accounted for 29 per cent of the total budget of the Island Government of Curacao. The number of employees of the Island Government of Curacao was 7,419 in 1980. Therefore, one could estimate that about 29 per cent of these jobs -- about 2,150 jobs -- were supported by offshore tax revenues. Even this estimate is conservative, because an additional 2,625 positions in the field of education and a further 2,000 jobs in "quasi-public" firms in Curacao were supported directly or indirectly by the Island Government.

This same calculation can be made with respect to the consolidated budget of the Netherlands Antilles (Central Government and Island Governments of Aruba and Curacao). The NAfl. 105 million in offshore tax revenues accounted for some 13.5 per cent of the consolidated budget of NAfl. 780 million in 1980. The total number of public sector employees in the Netherlands Antilles in that year was 17,390. Applying the offshore share of the total budget, one calculates that about 2,340 public sector jobs were supported by revenues generated from the offshore financial sector.

It is impossible to determine with any degree of accuracy the specific number of jobs that are attributable to the activities of the offshore financial sector in the absence of intensive further investigation.

However, overall orders of magnitude can be estimated if a reasonably wide margin of error is permitted.

Direct employment in the offshore sector amounts to about 1,300 jobs. An additional 700 jobs can be added conservatively for a wide range of sectors (construction, tourism, office supplies, domestic help, personal services, etc.) providing goods and services to the offshore sector and its employees. Finally, some 2,000 or more public sector employees are supported from offshore sector revenues. This adds up to a total of about 4,000 jobs in the Netherlands Antilles that are attributable directly or indirectly to the activities of the offshore financial sector.

V. CONCLUSIONS

The preceding sections of this report have provided an assessment of the economic importance of the offshore financial sector to the Netherlands Antilles. The contributions to foreign exchange earnings are significant to the Netherlands Antilles as a whole, since the nation must import nearly all commodities required for human habitation. Second, the government revenue provided by the offshore sector is important not only to support the activities of the public sector itself, but also the efforts of the various governments to stimulate or sustain economic activity in other sectors. Third, the direct and indirect employment generated by the offshore sector, while not large in an absolute sense, is nevertheless important to an economy the size of the Netherlands Antilles. Since most of these contributions are made on Curacao, the importance of the offshore sector to that island is much more highly pronounced.

A final contribution of the offshore sector must be placed in qualitative rather than quantitative terms, but is far from inconsequential. It is based on the attitudes and outlook of the Antilleans themselves. There is a clear awareness of the largess bestowed on the Netherlands Antilles, first by the oil companies and later by generous Dutch aid. The economy was pulled out of and later protected from longstanding conditions of poverty and stagnation. Over the past two decades, major efforts have been exerted to create a sustainable set of economic activities to maintain standards of living, and the record of these efforts has been mixed.

Antilleans from all sectors currently view the offshore financial sector as the core "engine of growth" for a set of international, service-oriented activities toward which the economy should evolve. Examining both recent experience and the prospective options open to the Netherlands Antilles, this conclusion seems warranted.

A. Implications of Reduced Offshore Activity

The implications of the potential loss of all or a major portion of the offshore sector are fairly clear cut. First, the Netherlands Antilles would experience a significant foreign exchange shortfall. As a result, austerity measures would be required to reduce consumption, and foreign debt levels would rise. The Netherlands Antilles would also seek additional levels of foreign assistance from the Netherlands. If such requests were honored, which is not very likely given the amounts required (and current trends confirm that aid flows are not likely to rise), it would prove detrimental to the felt need for the Netherlands Antilles to become more independent.

The loss of offshore sector revenues would also require major cutbacks in government expenditures. To indicate the consequences of major revenue losses, a distinction must be drawn between the Central Government and the Island Government of Curacao. Based on past experience and on current assessments by government officials, the most likely first step for both governments would be to limit capital expenditures to the largest extent possible. Both governments would then reduce wages and employment in the public sector, and end expenditures on new development projects.

If further cutbacks were necessary, the Island Government of Curacao would then reduce funding for health care and subsidies for housing projects for the poor. These would be followed by declines in educational expenditures. If still further budget cuts were required, Island Government support of private and government-owned firms would be reduced.

Revenue shortfalls for the Central Government would result in declines in funding for university education, reductions in transfers to the small islands, and finally in cutbacks on contributions to certain private and public sector firms (e.g., water and electricity production on Bonaire and St. Maarten, the hotel sector on Bonaire, etc.). As a result, both public services and private sector economic activity would deteriorate.

If faced with a major decline in their international transactions, the offshore banks and trust companies would either reduce their levels of activity, cease their operations altogether, or move to other countries. The employees who do not emigrate would probably assume the positions of less qualified workers in other sectors, who in turn would be forced to seek new positions. Economic conditions would clearly deteriorate, particularly on Curacao, as the upward spiral of economic contributions of the offshore sector were reversed.

In the final section of the questionnaire, the senior management of the offshore firms were asked to provide subjective assessments of the importance of the U.S.-Netherlands Antilles tax treaty in supporting their firms' activities. When asked what portion of their business is benefitted by provisions in the tax treaty, the executives provided a wide range of responses, from a low of 5 per cent to 100 per cent. The average response was slightly above 50 per cent. This answer corresponds closely with that of the following question, which asked what percentage of the responding firms' transactions would be eliminated in the event that the current tax treaty were revoked, and the special treaty benefits were lost. The average response was a 52 per cent reduction in transactions. Finally, the firms were asked to estimate the number of positions that would be eliminated as a result of the revocation of the current tax treaty. The answer was that a total of 487 jobs are at stake, or roughly one half of total employment in the offshore sector.

B. Political Considerations

The basic charge of this study has been to examine the role of the offshore financial sector in economic terms. It is necessary and fitting, however, to assess this role within the context of the current political climate in the Netherlands Antilles.

The Netherlands Antilles are today very much at an historic crossroads, since the islands are now in the process of establishing a new form of political organization. A joint Dutch-Antillean "Committee of Seven" has been meeting since February of this year to study the long-debated question of Aruban status aparte, or separation from the other Antilles, and perhaps ultimately from the Netherlands. The Committee is charged with advising the respective governments of the Netherlands and the

Netherlands Antilles on the separation question, leading to a Roundtable Conference which will make those constitutional changes required to effect separation.

No Antillean government or private official with whom the SRI study team met doubted the fact that Aruba will ultimately — within the next three to five years — be separated from the other islands. In fact, the Committee of Seven has even surprised many observers with the progress it has made in recent meetings, although this progress has at times been interrupted, given the delicate political nature of the discussions. In the absence of further delays, observers expect that the Committee of Seven will soon complete its work, and a Roundtable Conference may convene as early as winter 1983.

While it is not within the scope of this report to examine the implications of these developments, several observations on the current and projected role of the offshore sector are worth noting. First, the delicate political negotiations on status aparte would be greatly complicated by an significant change in forecast for Curacao's economic future, in which the offshore sector plays a large part. Second, assuming that status aparte is achieved, then the importance of currently productive economic sectors in Curacao (in terms of generating income and tax revenues) will become more pronounced, since Aruba would presumably no longer be supporting the activities of the Central Government.

The historically stable climate of the Netherlands Antilles has only once been interruped by significant social unrest — in May of 1969 — when riots erupted as a result of deteriorating economic conditions and high unemployment. In response, the Government of the Netherlands Antilles, with Dutch assistance, substantially increased its social involvement to help meet the needs of its people, and calm was restored relatively quickly.

Since that time, active efforts have been made to create and expand private sector sources of income, employment and revenue, and the most successful case has been that of the offshore financial sector. The economic impact of this sector on the Netherlands Antilles economy has grown to the point of being significant and highly positive.

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APPENDIX 1

HISTORY OF TREATY RELATIONSHIPS OF THE NETHERLANDS ANTILLES

A critical factor underlying the growth of the offshore financial sector of the Netherlands Antilles has been the treaty relationships between that nation and other countries, particularly the United States and the Netherlands. The history of these relationships evolved after 1948, when the United States and the Netherlands concluded a tax treaty, one objective of which was to avoid the double taxation of dividends and interest. Under this treaty, the United States reduced its withholding tax (normally 30 per cent) to 15 per cent on dividends and to nil on interest and royalty payments.

In 1955, a protocol was signed extending the provisions of the U.S.-Netherlands treaty to the Netherlands Antilles. Since the latter country was then charging only 3 per cent profit tax on offshore companies, it became extremely advantageous to route international financial transactions through Netherlands Antilles subsidiaries. The United States indicated that such treaties were not intended to result in an overall reduction in withholding taxes, but rather to avoid double taxation.

As a result of this objection, a protocol was signed between the United States and the Netherlands Antilles in 1963, and in this protocol U.S. withholding taxes were raised to 30 per cent, with the following exceptions: if the shares of the Netherlands Antilles firm receiving the U.S.-sourced dividends, interest or royalty income are owned either totally by individuals residing in the Netherlands Antilles, by individuals residing in the Netherlands, or by a Netherlands corporation, then the U.S. withholding tax would be 15 per cent on dividends and nil on interest and royalties. The corresponding Netherlands Antilles profit tax would be 3 per cent (following a 2.4 per cent tax rate on the first NAfl. 100,000 in profits).

In addition, the protocol provided that finance, investment, patent-holding and copyright companies based in the Netherlands Antilles can elect for their U.S.-sourced dividends to be taxed at 15 per cent and interest and royalties at 30 per cent (2.4 per cent on the first NAfl. 100,000), in which case the U.S. withholding tax would be reduced to 15 per cent for dividends and nil for interest and royalties. One of the conditions for these benefits is that the Netherlands Antilles authorities must be prepared to exchange information with the U.S. authorities for the prevention of tax evasion.

The 1963 protocol removed the particularly favorable elements of the 1955 protocol, but the Netherlands Antilles has remained an attractive offshore center, especially because finance subsidiaries of U.S. firms pay profit taxes on interest rate margins rather then on gross interest payments, as described in the body of this report. Additional provisions favor purchases of real estate in the United States by non-U.S. citizens through Netherlands Antilles corporations, but these advantages have been greatly reduced by the enactment of the Foreign Income Real Property Tax Act (FIRPTA) in November 1980. The FIRPTA is designed to tax foreigners on their gains attained on the sale of U.S. real estate.

The United States has expressed an interest in revising the 1963 protocol, in order to correct existing possibilities for abuse of the provisions in the current protocol and to incorporate new concepts currently embodied in more recently negotiated tax agreements with other countries. The U.S.-Netherlands Antilles Protocol has been in the process of renogotiation since 1980.

APPENDIX 2

OFFSHORE FINANCIAL SECTOR QUESTIONNAIRE *

1. Name and address of firm:

____

____

____

____

2. Name of individual who can be contacted in the event that clarification of responses is required:

____

3. Some firms engage in both local and offshore business, and it is often difficult to allocate employee time and expenses assigned to each. What percentage of the overall business activities of your firm do you estimate to be related to offshore transactions, and what percentage to local transactions?

Offshore transactions:	_______	per cent
Local transactions:	_______	per cent
Total	100	per cent

EMPLOYMENT

4. What is the total number of individuals currently employed by your firm (i.e., on the company payroll)?

Number of employees: ___________

5. How many of your current employees are citizens of the Netherlands Antilles, and how many are citizens of other countries (including the Netherlands)?

Netherlands Antilles nationals: ______________

Foreign nationals: ______________

* When completing this questionnaire, please make sure that answers reflect the consolidated operations of your firm (i.e., include the operations of directly related affiliates).

SRI International
1611 North Kent Street • Arlington, Virginia 22209 • (703) 524-2053

(Over)

Offshore Financial Sector Questionnaire (Con't)
Page 2

6. Please give a breakdown of your current employees (i.e., those on the payroll) according to the following job classifications.

	Number of Employees
A. Executives (Directors, Officers)	
B. Division chiefs	
C. Account officers	
D. Attorneys	
E. Accountants	
F. Clerks	
G. Secretaries	
H. Computer programmers, operators	
I. Office maintenance personnel	
J. Other (specify) ________________	
________________	

7. What was the total amount of salaries and benefits (gross figure) payed to your employees in 1981 (or latest year available)?

Total compensation (salaries & benefits): NAfl. ____________ Amount ________ Year

8. Please list to the extent possible the total number of individuals employed by your firm (i.e., on the company payroll) during the following years at any given point in time during the year:

Total number of employees:

1975: ________ 1979: ________ 1980: ________ 1981: ________

9. Considering the total number of employees in your firm who are engaged in offshore financial activities, please give your estimate of the percentage of this group which is based in each of the different island territories of the Netherlands Antilles.

	Aruba	Bonaire	Curacao	St. Maarten	Other	Total
Percentage of employees:						100

LOCAL EXPENDITURES AND EXPENSES

10. Please provide figures on expenses incurred in the following categories. This information should be available in your firm's income statement or in tax return material. If possible, fill in data for both 1980 and 1981. Information for 1980 is especially important.

Local Expense Categories	Annual Expenses (NAfl.)	
	1980	1981
A. Plant and equipment		
B. Utilities: Total		
Electricity		
Telephone/telex		
Water		
Other (specify) ____________		
C. Office supplies		
D. Rent on property		
E. Fees: Total		
Notaries		
Accountants		
Legal services		
Other (specify) ____________		
F. Taxes: Total		
Salary withholding tax		
Corporate income tax		
Real estate tax		
Other taxes		
G. International travel via ALM Airlines		

(Over)

11. Over the course of one year, approximately how many foreign visitors come to the Netherlands Antilles for the purpose of carrying out business with your firm related to offshore financial activities? In your estimate, what is the approximate length of their stay?

Annual number of visitors: ____________

Average length of stay per visit: ____________

ASSESSING THE IMPORTANCE OF THE U.S.-NETHERLANDS ANTILLES TAX TREATY

(Based on subjective assessments of senior management)

12. Approximately what portion of the business carried out by your firm is benefitted by provisions in the tax treaty? (check one answer)

0 to 20 per cent _______
20 to 40 per cent _______
40 to 60 per cent _______
60 to 80 per cent _______
80 to 100 per cent _______

13. If the current tax treaty were revoked, and the special benefits were lost, approximately how much (in percentage terms) of the offshore financial transactions of your firm would be eliminated?

Percentage reduction in transactions: ____________

14. In your estimate, approximately what number of positions in your firm would be eliminated as a result of a change in the U.S.-Netherlands Antilles Tax Treaty such as that described in question 12?

Potential jobs eliminated: ____________

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U.S. Department of Justice
Office of the Deputy Attorney General

The Deputy Attorney General
Washington, D.C. 20530

[illegible]

November 5, 1982

Mr. John E. Chapoton
Assistant Secretary, Tax Policy
Department of the Treasury
15th and Pennsylvania Avenue, N.W.
Washington, DC 20220

Dear Mr. Chapoton:

As you know, the Department of Justice is interested in the new income tax treaty between the United States and the Netherlands Antilles. For your information, I am enclosing herewith a copy of a February 10, 1982, letter from Assistant Attorney General Glenn Archer to International Tax Counsel Alan Granwell. Also, the views of the Justice Department are reflected in a July 6, 1982, letter from Congressman Stark to Congressman Gibbons, a copy of which is also enclosed.

The Justice Department has again reviewed the various proposals of the Netherlands Antilles involving exchange of information, identification of American owners, bank secrecy and bearer shares. Our view continues to be that, if a treaty which contains such provisions is entered into, it would be highly beneficial to United States law enforcement interests.

We have especially focused on the question of whether there is any problem with limiting the use of the special system for identifying American ownership to that purpose and for criminal matters, and have concluded that such a limitation is appropriate and beneficial.

The Justice Department stands ready to assist the Treasury Department in working out the details of the new treaty. For this purpose, your contact should be Assistant Attorney General Archer, Tax Division, telephone 633-2901.

Sincerely,

Edward C. Schmults
Edward C. Schmults
Deputy Attorney General

Enclosures

cc:
Robert Cole, Esq.

DISTRICT OF COLUMBIA
SELECT NARCOTICS

CONGRESS OF THE UNITED STATES
HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515

July 6, 1982

RECEIVED
JUL 09 1982
O.L.A.

Hon. Sam Gibbons
Chairman
Subcommittee on Trade
Committee on Ways and Means
233 Cannon House Office Building

Dear Mr. Chairman: Sam

Last March, during the Subcommittee's hearings on the Caribbean Basin Initiative, I suggested to you and the Subcommittee Members the idea of requiring in the trade provisions that a Nation cooperate with the United States in the exchange of certain tax information as a condition for receiving benefits under Title I of the President's proposal. I noted the severe law enforcement problems caused by tax evasion, the laundering and deposit of organized crime and narcotics money, etc., and pointed to the example of the Netherlands Antilles and the Cayman Islands.

Since then it has been brought to my attention by the Justice Department, that the Government of the Netherlands Antilles is in fact a strong friend and ally of U.S. law enforcement agencies, particularly the U.S. Customs Service, the Drug Enforcement Administration, and the Criminal Division of the Justice Department by providing assistance on a regular and frequent basis, significantly adding a dimension of effectiveness to our law enforcement efforts in the Caribbean. I want to join with U.S. law enforcement officials in applauding those efforts by responsible law enforcement officials in the Netherlands Antilles who are equally desirous of battling narcotics smuggling and organized crime activities.

Therefore, to the extent the Record is still open on CBI issues, I would like to delete my reference to the Netherlands Antilles in my previous letter. Obviously, however, some others in the Caribbean are not as cooperative, and I continue to believe we must maintain pressure on those who, unlike the Netherlands Antilles, continue to harbor illegal monies.

Thank you for your consideration of this request.

Sincerely,

Pete
Fortney H. (Pete) Stark, M.C.

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State of Florida
Office of the Governor

Statewide Grand Jury
425 Lewis State Bank Building
Tallahassee, Florida 32301
Telephone (904) 487-2807

Bob Graham
Governor

Legal Advisor

Hon. Robert E. Stone
State Attorney
19th Judicial Circuit

Chief Prosecutor

R. Scott Palmer

September 15, 1983

Dr. Louis R. Nahr
Attorney General of the
Netherlands Antilles
Courthouse, Wilhelmaplein 4
Curacao, Netherlands Antilles

Dear Dr. Nahr:

Once again I would like to thank you for the helpfulness and many courtesies extended me while in Curacao during the week of August 14, 1983.

At a time when the circumstances of an investigation and prosecution become as extraordinarily complex as these about which I have been speaking to you, it is indeed fortunate to have the occasion to work through and coordinate these matters with a person possessing the consummate credentials as you do and who represents his government so impeccably. I do trust that you have not found these meetings an inconvenience to you or your staff.

Until our next meeting, I am

Sincerely,

R. Scott Palmer
Chief Prosecutor

RSP:ep

14-5-7

U.S. Department of Justice
Drug Enforcement Administration

Washington, D.C. 20537

MAY 12 1983

Honorable Jack Brooks
Committee on Government Operations
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Brooks:

I recently received a copy of the House Commerce, Consumer and Monetary Affairs Subcommittee's News Release regarding hearings which were scheduled for April 12 and 13, 1983 on "Tax evasion through the Netherlands Antilles and other tax haven countries." In reviewing this press release, I was concerned that no mention was made of the cooperation that does exist between the United States and the Netherlands Antilles in the area of drug law enforcement.

The Drug Enforcement Administration, in concert with other concerned Federal agencies, has been working closely with the Government of the Netherlands Antilles for several years. This cooperation has resulted in significant successes in interdicting drug laden vessels which were destined for the United States.

Two specific examples of what has been accomplished through DEA's close cooperation with the Netherlands Antilles are the successes of Operation Tiburon and Operation Trampa. Both of these operations involved aircraft overflights of the northern coastline of Colombia, the Bahamas and other target areas for the purpose of identifying suspect vessels and aircraft capable of smuggling contraband into the East and Gulf Coasts of the United States. Aircraft utilized to perform these overflights were based out of several locations including the Netherlands Antilles.

Operation Tiburon, the predecessor to Operation Trampa, resulted in the seizure of 70 vessels and 932,963 pounds of marihuana and the arrest of 368 drug violators. Operation Trampa, which is still ongoing, has resulted in the seizure of 239 vessels, 3,255,327 pounds of marihuana, 52,428 dosage units of methaqualone, 9,200 dosage units of phenobarbital, 971 pounds of cocaine, 4.25 pounds of Dilaudid and the arrest of 1,050 drug law violators.

Honorable Jack Brooks
Page 2

The cooperation we received from the Netherlands Antilles played an important part in achieving the above-mentioned successes. Certainly the United States would be remiss in the area of foreign affairs not to extend to the Netherlands Antilles our Government's appreciation for the cooperation that country has extended to the United States in the area of drug law enforcement.

Sincerely,

Francis M. Mullen, Jr.

Francis M. Mullen, Jr.
Acting Administrator

cc: Honorable Doug Barnard
Chairman
Subcommittee on Commerce, Consumer
and Monetary Affairs

STATE OF FLORIDA
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Telephone (904) 487-2807

Bob Graham
Governor

Legal Advisor
Hon. Robert E. Stone
State Attorney
19th Judicial Circuit

Chief Prosecutor
R. Scott Palmer

September 15, 1983

Honorable Lionel Capriles
Chairman of the Board
Maduro & Curiel's Bank N.V.
Curacao, Netherlands Antilles

Dear Mr. Capriles:

I find that once again I have occasion to thank you for the helpfulness shown me with regard to the investigative matters which we discussed during the week of August 14, 1983 during my second visit to Curacao.

It is especially gratifying to have obtained such cooperation and assistance at a time when the particular matter is of such magnitude and complexity. An already extremely difficult case could prove to be totally frustrating without such fine cooperation as shown by you and your very capable staff.

Thanking you again, I am

Sincerely,

R. Scott Palmer

R. Scott Palmer
Chief Prosecutor

RSP:ep

Jop,
In my today's call,
I request [illegible] [illegible].
Do you know this letter?

U.S. Department of Justice
Office of the Deputy Attorney General

The Deputy Attorney General
Washington, D.C. 20530

January 30, 1984

Mr. Harold Henriquez
Minister Plenipotentiary for Netherlands
Antilles Affairs
Royal Netherlands Embassy
4200 Linnean Avenue, NW.
Washington, D.C. 20008

Dear Mr. Henriquez:

We have reviewed your letter of January 4, 1984, expressing concern about the methods used by an Assistant United States Attorney in the Eastern District of Missouri to obtain evidence from the Netherlands Antilles.

We have discussed this issue with the United States Attorney responsible for the Assistant's activities, and he has assured us the approach used by the Assistant, who is inexperienced in the area of foreign evidence gathering, will not be repeated. We have been advised that the Assistant made the independent approach to the Curacao Tourist Board in an effort to obtain some general information regarding Curacao's criminal justice system in order to familiarize himself with its overall structure and operation, but that he intended to utilize established channels in order to obtain any actual exchange of information. At our request, the United States Attorney has reiterated to his entire office, and to this Assistant in particular, the correct procedures and channels to follow in foreign evidence gathering.

Please be assured that we appreciate the generous cooperation we have received from the Netherlands Antilles in our law enforcement efforts, and that we look forward to continuing that relationship of cooperation.

Sincerely,

Edward C. Schmults

cc: Thomas D. Dittmeier
United States Attorney
Eastern District of Missouri
St. Louis, Missouri

Philip T. White, Director
Office of International Affairs
Criminal Division

Copy for U.S. and N.A. Government officials only. Any public release of this document should have the Nahr speech deleted.

Record of Award Ceremony

U.S. Department of Justice
William French Smith
Attorney General
Presiding

to

Luis R. Nahr
Attorney General of the
Netherlands Antilles

in the presence of:

D.F. Martina
Prime Minister of the
Netherlands Antilles

April 3, 1984

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DEPARTMENT OF JUSTICE AWARDS CEREMONY - April 3, 1984

Mr. D. Lowell Jensen, Associate Attorney General, Department of Justice

Mr. Jay B. Stephens, Deputy Associate Attorney General, Department of Justice

Mr. Michael Bell, Department of Justice

Mr. Roger M. Olsen, Deputy Assistant Attorney General, Tax Division, Department of Justice

Mr. Francis M. Mullen, Jr., Administrator, Drug Enforcement Administration, Department of Justice

Mr. Stan McQueeny, Federal Bureau of Investigation

Mr. Richard Brown, Director, Office of Caribbean Affairs, Department of State

Mr. Roger Pierce, Netherlands Antilles Desk, Department of State

Mr. John Harris, Department of Justice

Mr. Robert Steinberg, Department of Justice

Mrs. L. R. Nahr

Minister President D. F. Martina

The Charge d'Affaires ad interim of the Kingdom of the Netherlands, H. E. Mr. G. J. van Hattum

The Minister Plenipotentiary for Netherlands Antilles Affairs, Mr. H. Henriquez

The Secretary to the Council of Ministers Mr. R. Lopez Ramirez

Mr. H. Stewart VanScoyoc, Charls E. Walker Associates, Inc.

Mr. Robert Cole, Cole & Corette

Mrs. Harold Henriquez

Mrs. D. F. Martina

Mr. Lasten, Government Information Officer

REMARKS FOR ATTORNEY GENERAL ON OCCASION OF AWARD CEREMONY HONORING LUIS R. NAHR, ATTORNEY GENERAL, NETHERLANDS ANTILLES

MR. ATTORNEY GENERAL, I TAKE GREAT PERSONAL PLEASURE AND PRIDE IN WELCOMING YOU, PRIME MINISTER MARTINA AND OUR OTHER DISTINGUISHED GUESTS TO THE DEPARTMENT OF JUSTICE TO THIS CEREMONY TO HONOR YOU FOR YOUR OUTSTANDING CONTRIBUTIONS TO INTERNATIONAL LAW ENFORCEMENT.

ON THIS OCCASION, I WANT TO EXPRESS OUR APPRECIATION AND SPECIAL GRATITUDE TO YOU, MR. ATTORNEY GENERAL, FOR THE EXEMPLARY COOPERATION AND ASSISTANCE YOU HAVE EXTENDED OVER THE COURSE OF MANY YEARS TO UNITED STATES LAW ENFORCEMENT AGENCIES. IN SO MANY INSTANCES, YOU HAVE PROVIDED VALUABLE INTELLIGENCE INFORMATION AND DOCUMENTARY EVIDENCE IN CRIMINAL MATTERS IN THE AREAS OF NARCOTICS TRAFFICKING AND ORGANIZED CRIME.

YOU HAVE DEMONSTRATED IN A VERY REAL AND CONCRETE WAY THAT YOU NOT ONLY SHARE OUR DEEP CONCERN OVER THE FLOW OF ILLEGAL DRUGS INTO BOTH YOUR COUNTRY AND OURS, BUT HAVE ALSO TAKEN STRONG, COURAGEOUS AND EFFECTIVE MEASURES TO STEM THIS FLOW. THE ASSISTANCE YOU HAVE PROVIDED US HAS CONTRIBUTED IN A MOST SIGNIFICANT WAY TO THE SUCCESS OF OUR ENFORCEMENT PROGRAMS AGAINST NARCOTICS TRAFFICKING AND ORGANIZED CRIME.

IN PUBLIC RECOGNITION OF YOUR ASSISTANCE TO US, THEREFORE, IT IS WITH GREAT PLEASURE THAT I PRESENT YOU WITH THIS CERTIFICATE OF ACKNOWLEDGEMENT AND APPRECIATION FOR YOUR OUTSTANDING ASSISTANCE TO THE UNITED STATES IN OUR EFFORTS TO COMBAT NARCOTICS TRAFFICKING AND ORGANIZED CRIME OPERATIONS. WE ARE MOST GRATEFUL TO YOU, AND LOOK FORWARD TO CONTINUED COOPERATION BETWEEN OUR TWO COUNTRIES.

TEXT OF AWARD TO LUIS NAHR

On behalf of the United States of America, the Attorney General William French Smith with profound respect and deep gratitude wishes to acknowledge and commend Luis Ramon Nahr, Attorney General of the Netherlands Antilles, for longstanding and steadfast assistance and cooperation with United States law enforcement agencies which, together with those of the Netherlands Antilles, are actively engaged in investigating and prosecuting persons involved in narcotics trafficking and smuggling and organized criminal activities.

Done this 15th day of March 1984 in the City of Washington.

W. F. Smith
The Attorney General of
the United States of America

STATEMENT OF PAUL A. LAUDICINA, DIRECTOR, INTERNATIONAL POLICY ANALYSIS GROUP, SRI INTERNATIONAL, ON BEHALF OF THE GOVERNMENT OF THE NETHERLANDS ANTILLES, ACCOMPANIED BY JOHN MATHIESON, SENIOR INTERNATIONAL ECONOMIST, SRI INTERNATIONAL

Mr. LAUDICINA. Thank you. My name is Paul Laudicina, and I am director of SRI International's International Policy Analysis Group which is located in Rosslyn, VA. This group conducts independent economic assessments for corporate and government clients.

My colleague, our senior international economist seated to my right, John Mathieson, and I appear before you today to answer whatever questions the distinguished members of this panel might have on the basis of research we completed 2 years ago under contract to the Government of the Netherlands Antilles.

I would like to add that the International Policy Analysis Group of SRI was retained by the Government of the Netherlands Antilles to conduct an independent and objective assessment of the economic impact of international financial activities on the Netherlands Antilles. We appear here today not as advocates of any particular position, but rather to report on those aspects of our research which might be of interest to this committee.

I now would like to briefly summarize the conclusions of our study. A copy of our complete report is available to the committee.

While our report was based upon data available through 1981, it is our understanding that more recent economic data further underscores the growing relative importance of the international financial sector to the Antillean economy.

The activities of the international financial sector in the Netherlands Antilles have grown rapidly since the mid-1970's, and as a consequence the contributions of the international financial sector to the economy of the Netherlands Antilles have expanded to the point of being highly significant. These contributions are particularly important to the island territory of Curacao, where most of the international financial firms are based.

Tax revenues and foreign exchange earnings are the principal benefits that the Netherlands Antilles derive from offshore operations. The offshore sector provided 43 percent of total profit taxes received by the Netherlands Antilles in 1980, and 61 percent of total profit taxes received in Curacao. These revenues were sufficient to cover 29 percent of total current expenditures of the island government of Curacao in 1980; and, as the Prime Minister pointed out, that percentage has grown to the point of being 25 percent of the combined Federal and island budgets.

The foreign exchange earnings contributed by the international financial sector have grown even more dramatically, by an average rate of 33 percent annually over the period 1976 to 1981. The international financial sector is now firmly established as one of the four service sector pillars earning foreign exchange needed to finance imports—the others in the Antilles being oil refining, tourism, and transportation services. The growth of exchange receipts from international financial activities in comparison with that of the other service sectors has been striking.

The multiplier effects of international financial sector operations on the other sectors within the economy are also considerable. Benefits are obtained directly or indirectly by the local service, supply, construction, and tourism industries.

Through tax payments, the international financial sector firms also directly support programs of and employment in the public sector. Many of the contributions of the international financial sector are in support of activities around which the Netherlands Antilles seeks to shape its future development.

Existing information supports the assertion that the international financial sector has far greater potential than other sectors within the Netherlands Antilles economy, such as oil refining, tourism, and manufacturing—the fortunes of which have declined since our study was conducted. In view of the economic alternatives open to the Netherlands Antilles, the international financial sector and the activities it creates constitute a major source of economic growth and stability.

The natural consequence of a significant decline in offshore transactions would be a sharp fall in exchange and revenue earnings, and a significant reduction in employment in the Netherlands Antilles. These developments would in turn require forceful measures to reduce the consumption of imports and decrease the public services and employment currently provided by various government entities.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF PAUL LAUDICINA, DIRECTOR, INTERNATIONAL POLICY ANALYSIS GROUP, SRI INTERNATIONAL

Mr. Chairman, distinguished members of the House Ways and Means Committee. My name is Paul Laudicina, and I am the Director of SRI International's International Policy Analysis group, located in Rosslyn, Virginia. This group conducts independent economic assessments for corporate and government clients. My colleague, our Senior International Economist John Mathieson, and I appear before you today to answer whatever questions the distinguished members of this panel might have on the basis of research we conducted two years ago under contract to the Government of the Netherlands antilles.

I would like to preface my brief substantive remarks by noting that SRI International, as a nonprofit, research and consulting organization, has no position on the legislation before this Committee. Furthermore, I would like to add that the International Policy Analysis group of SRI was retained by the Government of the Netherlands Antilles to conduct an independent and objective assessment of the economic impact of offshore financial activities on the Netherlands Antilles. The Government of the Netherlands Antilles provided us with access to all sources of information we needed to perform our research assignment, and in no way predetermined for us the results of this study. We completed our research assignment for the Government of the Netherlands Antilles in September 1982 and have not been under contract with the Government since that time. We appear here today not as advocates of any particular position, but rather to report on those aspects of our research which might be of interest to this Committee.

I now would like to briefly summarize the conclusions of our study for the Government of the Netherlands Antilles. A copy of our complete report is available to the Committee.

The activities of the offshore financial sector in the Netherlands Antilles have grown rapidly since the mid-1970's, and as a consequence the contributions of the offshore sector to the economy of the Netherlands Antilles have expanded to the point of being highly significant. These contributions are particularly important to the Island Territory of Curacao, where most of the offshore firms are based.

Tax revenues and foreign exchange earnings are the principal benefits the Netherlands Antilles derives from offshore operations. Profit taxes earned from the offshore sector have grown at an average annual rate of over 22 percent since 1976, *rising from NAfl. 50 million ($28 million) in 1976 to NAfl. 137 million ($77 million)* in 1981. The offshore sector provided 43 percent of total profit taxes received by the Netherlands Antilles in 1980, and 61 percent of total profit taxes preceived in Curacao. These revenues were sufficient to cover 29 percent of total current expenditures of the Island government of Curacao.

The foreign exchange earnings contributed by the offshore sector, which include the combined inflows for tax remittances and operational expenditures, have grown even more dramatically, by an average rate of 33 percent annually over the 1976–1981 period. The total foreign exchange earnings from the offshore sector in 1981 amounted to NAfl. 264 million ($147 million), an amount which covered 20 percent of the merchandise trade deficit in that year. Since nearly everything consumed in the Netherlands Antilles must be imported, a high priority is placed on any economic activity that generates foreign exchange. The offshore sector is now firmly established as one of the four service sector "pillars" earning foreign exchange (the others being oil refining, tourism and transportation services) needed to finance imports. The growth of exchange receipts from offshore activities in comparison with that of the other service sectors has been striking.

Direct employment in the offshore sector, as calculated by an SRI International survey of the offshore firms, has grown roughly threefold since the mid-1970s, to a current level in excess of 1,000 employees. This is particularly important for Curacao, where official estimates place unemployment rates at levels of 20 percent or more. On the basis of conservative assumptions, it can be estimated that some 4,000 or more workers in the private and public sectors (mainly in Curacao) depend directly or indirectly on the offshore sector for their employment.

While the direct employment impact of the offshore sector is not as significant as revenue and exchange earnings, the "multiplier effects" of offshore sector operations on other sectors within the economy are considerable. Benefits are obtained directly or indirectly by the local service, supply, construction and tourism industries. Through tax payments, the offshore firms also directly support the programs of and employment in the public sector.

Many of the contributions of the offshore sector are in support of activities around which the Netherlands Antilles seeks to shape its future development. While data deficiencies prohibit strict comparisons of sectoral developments over time, existing information supports the assertion that the international service sector—including offshore finance—has far greater growth potential than other sectors within the Netherlands Antilles economy, such as oil refining and manufacturing, at least in the near term. In view of the economic alternatives open to the Netherlands Antilles, the offshore financial sector and the activities it creates constitute a major source of economic growth.

The natural consequence of a significant decline in offshore transactions would be a sharp fall in exchange and revenue earnings, and an eventual reduction in employment in the Netherlands Antilles. These developments would in turn require forceful measures to reduce the consumption of imports and decrease the public services and employment currently provided by various government entities.

Following a lengthy period of deterioration and stagnation, the Netherlands Antilles economy has in recent years shown clear signs of revival. An almost total dependence on oil sector operations in former years has been replaced gradually by a more diversified set of productive economic activities. The offshore financial sector has played a major role in this evolution and improved outlook, and its contributions are likely to assume even greater importance as current political developments evolve.

Mr. JENKINS. Thank you very much for your testimony.

Mr. Guarini.

Mr. GUARINI. Thank you very much for the report and for your statement, Mr. Prime Minister.

As I understand it, there are three major industries that you have. You have oil, you have tourism, and you have banking. Are they the mainstay of the economy of the islands, basically?

And could you comment on the political stability problem that you would have if you lost your economic security in any of these areas?

Prime Minister MARTINA. Yes, I would like to confirm that our economy is based on four pillars: Oil refining—but I have to say that oil is being imported, and the oil has lost its significance, especially because of the U.S. energy policy.

We used to have two large oil refineries, one owned by Exxon, an American multinational, and the other one owned by the Shell Co. They used to refine a throughput capacity of 1 million barrels a day refined product. But they have reduced their throughput capacity now to approximately 380,000 barrels a day.

So that is a substantial decrease in throughput. It is a substantial decrease in revenues and employment, and today they are facing very serious problems because of the changing situation of oil on the oil international scene. One of the companies lost the American market, that is, the Shell Co.

Tourism is also one of our pillars. We have been confronting a very serious problem because of the world recession. Most of our tourists are from the United States. Because of the Venezuelan problem, the monetary problem in Venezuela, we have lost about 20 to 25 percent of our visitors. So we are confronted with a problem in that respect.

Another sector is also the services in the field of transportation. It is known to you that transportation has been facing—international transportation has been facing very much problems lately.

And our fourth sector is the international finance sector, that has been contributing, as I said before, a quarter, 25 percent of our combined revenues. So it means that if we are not able to secure and guarantee and consolidate those sectors, we are facing a very serious problem, because we have not got much alternative to substitute for one of those sectors.

The islands are very poor so far as raw materials are concerned. We have not got sources. So losing the international finance sector will mean a deadly blow to the economic stability and consequently will create social conflict, social tension, that will have its effect on our political life and our ability to preserve and maintain our democratic life on the islands.

Mr. GUARINI. Mr. Prime Minister, is there any way that you could replace these lost revenues within your country? Is there any possibility of economically being secure as a nation or as an island in the Antilles if you lost this banking revenue?

Prime Minister MARTINA. We have been trying for the last 10 years, trying every possible avenue, and we have not been successful, because of a very simple reason: that we have no raw materials, no resources whatsoever on the islands.

Mr. GUARINI. I understand that on some islands you have to have desalinization of water, and that you have very few natural resources, is that correct?

Prime Minister MARTINA. It is true to say that, even water, being one of our basic needs, we have to desalinate sea water for water consumption both for households and industry. So this is a very expensive enterprise, but we have to do that because even in that respect we have not been blessed by nature.

Mr. GUARINI. I understand that Holland had indicated that the islands, the Antilles, will be given their independence within the next decade. Could you make a comment as to what the timing would be if this economic loss had taken place, how it will affect your political stability?

Prime Minister **Martina**. Definitely it is true to say that so far as the constitutional development is concerned, we are in the process of establishing a higher degree of autonomy and independence. The island of Aruba, which is one of the six islands, will obtain in January 1986 a special status. That is to say that it will, on its way to independence, establish a special status to achieve its independence in 1996. Of course, this results in a weakening of our economic base.

All those developments together will have very serious negative effect on our economic situation.

Mr. **Guarini**. Have you cooperated with the Internal Revenue Service and the U.S. Government in all regards and been a very cooperative partner, or has there been much friction between our countries?

Prime Minister **Martina**. Well, contrary to what has been said and what is believed in Washington, we have been giving the U.S. Government all the necessary cooperation. Because of that, the U.S. authority, Attorney General Smith, a few weeks ago awarded our attorney general with this achievement. And I can confirm that we have been cooperating with the United States in combating crimes, drug trafficking, and we are willing to explore every avenue to strengthen our cooperation with the United States.

Even in our negotiations with the Treasury, we have concluded to override our own bank secrecy by virtue of the treaty, so to establish a modern and far-reaching exchange of information relationship.

Mr. **Guarini**. Well, Holland up until now has been the motherland of the Antilles, and I assume it has been a strength for the Antilles socially, economically, and politically. If independence comes within the next 10 or 12 years and you do not have this income to fall back on, would there be in your mind any social or political unrest in your country?

Prime Minister **Martina**. Well, of course we are trying hard to prevent any negative development. But it is true to say that if we are not able to secure and to consolidate our present economic base that the constitutional foundation and the political and social stability on our island will certainly be endangered.

Mr. **Guarini**. Thank you very much, Mr. Prime Minister.

Mr. **Jenkins**. Mr. Duncan.

Mr. **Duncan**. Thank you, Mr. Chairman.

I have no particular questions, other than to thank the very distinguished panel, which gives us some things to think about. And I know your testimony will be most helpful in finalizing legislation in this matter. Thank you.

Thank you, Mr. Chairman.

Mr. **Jenkins**. Mr. Prime Minister, let me ask one question. I know for the past couple of years a lot of tax treaties in the Caribbean countries and others have been counseled. I guess, for a variety of reasons, some of that information was not being provided that was needed.

As I understood your testimony, part of which was not in the written portion, you have just arrived at an agreement as far as providing the information that Treasury is requesting?

Prime Minister **Martina**. We have in our discussion and negotiation with the Treasury Department proposed our firm commitment to have provision in the new treaty that has to be finalized—the negotiation has to be finalized—to establish rules and regulations for exchange of information so far as our bank secrecy is concerned, and also the overriding of our bearer share system.

That is to say that in our new treaty we will have provisions, rules, and regulations to deal with that problem so far as the exchange of information is concerned.

Mr. **Henriquez**. What has been delaying the conclusion of the agreement that you are looking for is, the Treasury Department seems to insist to have all the implementation and regulation also considered by them before they decide to agree to a proposal.

So what usually is the case is that we reach an agreement, sign a treaty, and then we work together on the implementation provisions of the treaty. In this case we have the reverse situation. The Treasury is insisting that before they reach total agreement they have a look also at the underlying implementation of the regulations.

Mr. **Jenkins**. So you see no problem with your negotiations with Treasury. There has been a tentative agreement reached so far as disclosure, full disclosure, is that right?

Mr. **Henriquez**. The Treasury Department has agreed to our proposal of overriding bank secrecy and the bearer shares, and you are quite correct, Mr. Chairman, that they are only looking at whether the implementation is sufficient to guarantee them all they want.

Mr. **Jenkins**. Thank you very much. Thank you, Mr. Prime Minister, for appearing before the committee.

Our next panel of witnesses is: Mr. Robert McIntyre, director of Federal Tax Policy for Citizens for Tax Justice; Mr. John Evans, advisory director, Morgan Stanley & Co.; Mr. Robert Loverd of the Morgan Guaranty Trust Co. of New York; Mr. Roberto G. Mendoza, executive vice president, Morgan Guaranty Trust Co. of New York; Mr. John Hyland, Jr., chairman, International Committee with Blyth Eastman Paine Webber Inc.; and Mr. Jeffrey Schaefer, senior vice president and director of research; and Mr. Bernard Aidinoff, counsel.

Gentlemen, we appreciate your appearing before the committee today and, unless there is some different order, we will commence with Mr. McIntyre.

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE

Mr. **McIntyre**. Thank you, Mr. Chairman.

Mr. Chairman, on behalf of Citizens for Tax Justice, I appreciate the opportunity to be here today. Our coalition of national public interest groups, labor unions, and grassroots citizens groups represents tens of millions of Americans, average taxpayers, who have a vital interest in fair and economically sensible tax laws.

It seems to me that the issues before the committee today with regard to the withholding tax can be broken down into two areas. Generally, the first question is an economic one: Do we want to encourage a continuation or even an increase in the recent surge of foreign capital into the United States?

And, second are the tax policy issues, which might be generally summarized as: Do we want the United States to become an international tax haven for foreign investors?

Now, on the first issue, the question of whether we want more foreign capital into the United States. One thing that has to be understood is that in deciding what to do with the dollars we are sending overseas to buy imports, foreigners have two choices: They can either buy our goods or they can buy our assets. That is, they can either spend dollars on the products that Americans make or they can lend dollars back to us for capital investment purposes.

Now, some people have said that foreign capital investment into the United States is a kind of "found money," that it is "free" money to us, that it helps us, and that it is no problem. We do not think that is true. In fact, by discouraging foreigners from buying our goods, as the current approach does by making investment in our assets more attractive, we have contributed substantially to our enormous trade deficit and cost thousands of Americans their jobs in export- and import-sensitive industries.

If current trends continue we will soon move into a position of being a net international debtor—along the lines of Third World countries. We do not think this is a direction that America should be headed in from an economic point of view.

In case the link is not clear between the recent infusion of foreign capital and rise in the dollar which has hurt our exports, let me articulate it one more time. The rise in the dollar that we have seen recently has been linked by almost everyone who has analyzed it to the increasing demand to invest in U.S. assets; and that demand is high because of high U.S. interest rates; and those rates are high in real terms largely because of our huge Federal budget deficits, which we encourage the committee to take all the steps it can to reduce.

In addition, however, the United States also provides an artificial incentive for foreigners to invest in U.S. assets by exempting the interest they earn from our tax, or from any tax, for that matter, if the borrowings by our companies are routed through the Netherlands Antilles.

Now, one thing to keep in mind about the current situation with the Netherlands Antilles is that the Antilles finance subsidiaries were first authorized by the Internal Revenue Service back in the 1960's in an explicit effort to boost the exchange rate on the dollar. It was part of a comprehensive policy designed to buttress and protect the price of gold. Although that policy became outdated with the advent of floating exchange rates, we have continued to allow avoidance of our withholding tax through the Netherlands Antilles.

As a result we have artificially boosted the dollar, which seems to me currently to be a totally misdirected policy. Instead, we should be trying to reduce our trade deficit in any way we can, to put people in export- and import-sensitive industries back to work.

And so, from an economic point of view, what we would like to see is an end to the Netherlands Antilles treaty and, in addition, enforcement of the withholding tax, perhaps at a slightly lower level, on Eurobonds in order to reach a balance between artificially stimulating investment here and artificially discouraging it.

Now, from a tax policy point of view the question, as I said earlier, is whether we want to replace the Netherlands Antilles tax haven with a much more substantial tax haven—the United States of America. Because all of the proposals here today to repeal the withholding tax in one form or another are designed to do exactly that.

We had witnesses here a few minutes ago from Guam suggesting that their island should become the tax haven. Perhaps we could divvy up eligibility for tax haven status among the congressional districts represented on this committee that might be politically acceptable. But it seems to me that all of those approaches are wrong from a tax policy point of view, as is current law and as are the proposals being put forward by those on the panel with me.

If we do become an international tax haven, other countries are likely to follow us and the world will become a universal tax haven, which is just the wrong answer from the point of view of tax fairness and from tax administration.

I would like to make a couple of comments on some of the things that have been said here earlier. To start with, the Treasury argued earlier that, since there are lots of opportunities for tax evasion in the world already, that it is not worth worrying about creating new ones. I suppose that theory would also apply to closing old ones.

We find that position to be indefensible. In fact, when opportunities to cheat are expanded, evasion increases; when they are reduced evasion goes down. We know that from experience. We know that the harder it is to cheat the less evasion we see.

It was also suggested by the Treasury earlier that foreign countries do not impose a withholding tax. That is absolutely not true. In almost every case, foreign countries will impose their tax and waive it, as we do, only when there is disclosure to the country of residence.

And that, by the way, is the issue here. Almost any foreigner who wants to invest in the United States can buy our bonds and pay a zero or very low rate of taxation in the United States, as long as the home country is notified that the foreign person has earned the income here.

So what we are talking about here is trying to expand our capital markets, not to honest foreigners, but to foreign tax evaders. In fact, if you were to put a disclosure requirement in any of these bills repealing the withholding tax, anyone who is supporting the bills will no longer support them. And you should ask them about that.

In conclusion, I want to point out that the people who are pushing to repeal the withholding tax now are the same group of people who a few years ago gave us accelerated depreciation and safe harbor leasing and told us we needed to imitate the English in the way we run our tax policy, rather than follow the Japanese, as people like I suggested, who have a system that taxes actual income. These same people are now coming in and saying we ought to imitate some of the Third World countries and run our country as an international net debtor on a tremendous scale. Again, they are telling us to reject the example of the Japanese, who impose a 20-percent withholding tax on their yen-denominated borrowings specifically in order to keep the yen down and encourage exports.

We think that, again, the Japanese have the better answer. In our view, the right approach here is to set up a system that does not artificially stimulate foreign investment into the United States.

You know, some people have said that the Reagan administration wants to reverse the New Deal. After listening to Treasury today, it appears that they may want to go further and reverse the American Revolution, too. Because under the policy suggested here today, we will be selling ourselves back to Europe.

[The prepared statement follows:]

Statement of Robert S. McIntyre, Director, Federal Tax Policy, Citizens for Tax Justice

I appreciate the opportunity to appear before the Committee today on behalf of Citizens for Tax Justice. Our coalition of national public interest organizations, labor unions, and grassroots citizens groups represents ten of millions of average American taxpayers who have a vital stake in fair, economically sensible tax laws. We are opposed to proposals to repeal, in whole or in part, the U.S. withholding tax on interest paid to foreign lenders. Instead, we urge the Committee to take steps to strengthen the tax.

Over the past few years, we have seen a troubling shift in the U.S. international investment position. Foreigners are now investing far more in the United States than Americans are investing abroad. From the middle of 1982 through the end of 1983, net foreign investment flowed into the United States at an average annual rate of $31 billion—equal to about one percent of our gross national product. In the second half of last year, the net inflow of foreign investment accelerated to an annual rate of more than $50 billion—or 1½ percent of the GNP. It is expected that sometimes next year the United States will join most of the world's developing countries as an overall international debtor—the first time we will have been in that situation since before World War I.[1]

This dramatic reversal in the U.S. investment balance from the historical pattern[2] is producing major, and to some degree conflicting, impacts on our economy. One the one hand, the sharp increase in foreign lending to U.S. borrowers has served as a helpful buffer against the harmful effects of the giant federal budget deficits on interest rates and inflation. But the large net inflow of foreign investment funds also has been part of a process that has driven up the exchange rate on the dollar to an unhealthy level. On balance, we believe that the serious damage to the economy that has resulted from the increase in the dollar's exchange rate substantially outweighs any advantages that may have accompanied the recent surge in foreign investment here.

From 1980 to the end of 1983, the trade-weighted real exchange value of the dollar against major foreign currencies increased by 45 percent. As a direct result goods produced in America have been made uncompetitive with foreign goods, thereby driving up our imports, reducing our exports, and costing many thoudands of Americans their jobs. This problem is reflected in our record merchandise trade deficit, which amounted to $65 billion last year and is expected to reach $110 billion this. Moreover, a longer run consequence of the high exchange value of the dollar has been to give some foreign competitors a beachhead in the American marketplace and to destroy export markets that took American firms many years to develop.

The link between the recent surge of foreign investment into the United States and the high exchange rate on the dollar is a straightforward one. Currently, the foreign exchange market is dominated by investment transactions, not by trade. As the 1983 *Economic Report of the President* explains:

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[1] *See* U.S. Dept. of Commerce, Bureau of Economic Analysis, *Survey of Current Business* (Jan. 1984), NIPA Tables 1.1 and 1.4; the 1984 *Economic Report of the President,* at 57.

[2] In the 1960-66 period, for example, U.S. net investment abroad averaged $4.2 billion a year—or 7/10 of one percent of the GNP. By the 1974-80 period, our net investment situation was still roughly in balance (with a small net capital outflow, averaging .06 percent of the GNP). *See* the 1983 *Economic Report of the President,* at 55; U.S. Dept. of Commerce, Bureau of Economic Analysis, *The National Income and Product Accounts of the United States, 1929-76 Statistical Tables,* Table 4.1 (Sept. 1981).

"What the rise of the dollar seems clearly to reflect is a rise not in demand for U.S. goods, but in the demand for U.S. assets. . . . In order to buy U.S. assets, foreigners must first acquire dollars. The increased demand for dollars drives up the exchange rate." [3]

Why are foreigners so keen to buy U.S. assets, that is, to lend money to U.S. borroers? "The major cause," says the 1984 *Economic Report of the President,* "is the increase in the U.S. real interest rate. . . . because U.S. assets now pay a higher expected real rate of return than foreign assets, they have become more attractive to hold." [4]

Any why have real U.S. interest rates risen so high? Again, the 1984 *Economic Report* points to the most significant reason: "a large decline in government saving, i.e., a large increase in the Federal budget deficit." [5] We agree with this analysis, and we continue to emphasize that reducing the long-term federal deficits and getting the government's fiscal house in order is imperative. [6] There is an additional reason, however, why foreign demand for investment dollars is so high. Current U.S. tax law artifically increases the after-tax yield foreigners can earn on U.S. investments by exempting from taxation many types of U.S.-paid interest, notably the interest paid on corporate "Eurobonds" issued through tax-haven finance subsidiaries.

The current federal tax rules governing interest earned by foreign investors on U.S. corporate bonds stem from the 1960s. In an explicit effort to protect the price of gold and to boost the exchange value of the dollar, the United States adopted a policy designed to discourage capital outflows from the United States and to encourage capital inflows into our country. The two-pronged strategy involved an "interest-equalization tax" on interest earned on loans from the United States to foreign borrowers and a tax exemption for interest paid on loans from foreigners into the United States. [7] The key element of the second prong of the policy was an IRS ruling authorizing the use of Netherlands Antilles finance subsidiaries to avoid the U.S. statutory 30 percent withholding tax.

Following the move the floating exchange rates in 1973, the interest-equalization tax was abandoned. But, although the IRS no longer grants favorable rulings on the utilization of Netherlands Antilles finance subsidiaries, American companies have continued to use that now questionable tax-haven strategy to avoid the U.S. withholding tax on their foreign borrowings and the Eurobond market has flourished.

Thus, the very purpose of allowing American companies to sell tax-exempt Eurobonds through Netherlands Antilles finance subsidiaries was to boost the exchange value of the dollar. Whatever the merits of that policy in the 1960s, its clear result today is to damage our trade balance and cost American jobs in import-sensitive and export sectors. We therefore believe that Congress should take immediate steps to close this tax-free "window" to the Eurobond market and to curb the artificial incentive for foreign investment in the United States.[8] Certainly, Congress should not want to enact legislation that might further stimulate the unhealthy inflow of foreign capital into the United States, as many of the witnesses today will suggest should be done.

In conjunction with an end to the Netherlands Antilles tax treaty, the Committee may want to consider legislation reducing the statutory withholding rate. We suggest that such a reduction be limited to the Eurobond market, and that the rate be set at a level consistent with the need to curb the current incentive for excessive foreign investment into this country without imposing artificial disincentives. A rate between 10 and 20 percent might be appropriate.[9] We also suggest extending

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[3] The 1983 *Economic Report of the President,* at 62.

[4] The 1984 *Economic Report of the President,* at 52–53.

[5] *5. Id.,* at 54.

[6] We enthusiastically support, for example, this Committee's contribution to the "down-payment" on reducing the long-term deficit, in the House-passed tax bill now pending in conference with the Senate.

[7] In addition, rules were established to encourage foreign subsidiaries of American companies to fund their investments overseas with foreign-generated capital and to discourage them from using funds borrowed in the United States.

[8] If increased direct foreign aid to the Netherlands Antilles becomes appropriate as a result of ending our treaty with that country, it would be a small price to pay for the benefits to our international trade position from curbing the artificial incentives for foreign investment in the United States that the current treaty creates.

[9] In this regard, it might be noted that the Japanese impose a 20-percent withholding tax on interest earned by foreigners on yen-denominated assets for the explicit purpose of keeping the

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the withholding tax to interest on U.S. bank deposits and other currently exempted short-term investments.

Beyond the economic issues involved here, there are other very important reasons why we favor strengthening rather than repealing the withholding tax on U.S. interest earned by foreigners. First of all, it should be noted that, for most foreign investors in U.S. securities, the withholding tax has little or no significiane—assuming the investors are not engaged in tax evasion in their home countries. By treaty, U.S. interest is exempt for citizens of Austria, Denmark, Finland, Germany, Greece, Hungary, Iceland, Ireland, the Netherlands, Norway, Poland, Sweden, and the United Kingdom, among other countries. Reciprocal rate reductions under other treaties include a 15 percent rate for Canada and Belgium, a 10 percent rate for France and Japan, and a 5 percent rate for Switzerland. And, even where a withholding tax is due, it genereally results in an offset against home country income taxes under standard foreign tax credit rules. Thus, to a large degree, outright repeal of the withholding tax would amount to a windfall to foreign governments, particularly Canada, whose citizens pay about 40 percent of the currently collected withholding taxes and a country that has shown great reluctance in negotiating mutual reductions in the withholding rate.

To benefit from treaty exemptions or home country foreign tax credits, however, foreign investors must, directly or indirectly, make their U.S. interest income known to their own country's tax administrators. As a result, the withholding tax is chiefly an issue for foreigners seeking to make investments in the United States *without* disclosing their income to their home governments. In fact, it is common knowledge that many of these "tax avoiders"—as they are politely but inaccurately known-are common cheats. As the March 1980 issue of *Euromoney* noted, U.S. banks and investment firms which advocate repeal of the withholding tax hope that repeal will enable them to earn commissions selling bonds to "foreign buyers anxious to shelter themselves from their own tax burdens at home." [10]

Unless the United States imposes a significant tax on investment income earned within its borders—subject to reduction or waiver under treaty and with disclosure to the country of residence—the United States will become a tax haven that foreigners can employ to avoid taxes in their home countries. In effect, simple repeal of the withholding tax would entail replacing one tax haven—the Netherlands Antilles—with another—the United States of America.[11] As a responsible member of the community of nations, the United States should not let itself be used in this fashion.

In addition, fairness requires that foreigners earning income from U.S. sources should not enjoy a tax benefit that is—quite properly—denied to Americans. The United States cannot guarantee that foreigners will pay taxes according to their ability to pay them, as we try to do with regard to our own citizens. But we can at least guarantee that foreign persons pay some reasonable amount of tax on their U.S.-source income.[12]

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yen from appreciating to the disadvantage of Japanese exports. In recent negotiations, the Japanese were adamant about keeping the tax in place.

It might also be noted that, in effect, what we are suggesting here is a version of Rep. Barnard's bill, with the critical difference that we would not repeal the tax for Eurobonds, but simply reduce it.

[10] At a 1980 hearing before the Subcommittee on Select Revenue Measures on a proposal to repeal the withholding tax, proponents of the measure made clear that non-disclosure was critical to them. If the tax were ended, but foreign governments were notified of interest payments to their citizens, said one pro-repeal witness, the sought-after foreign investors "simply . . . would not buy the bonds." *Hearings on Minor Tax Bills,* Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 96th Cong., 2d Sess. 136 (June 1980). The Subcommittee did not report the measure.

[11] Testifying before the Ways and Means Oversight Subcommittee in 1979, Assistant Attorney General M. Carl Ferguson defined a "tax haven" as "a nation which affords secrecy to investors and permits the accumulation of wealth without any significant tax burden." *Hearings on Offshore Tax Havens,* Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 96th Cong., 1st Sess. 164 (April 1979). With no withholding tax and no disclosure requirements with regard to interest income earned by foreigners, the United States would come squarely within this definition.

[12] Although the provision of the pending Senate tax bill which phases out the withholding tax entirely attempts to restrict the sale of withholding-exempt bonds to bona fide foreigners, it seems likely that American tax evaders would be able to avoid these restrictions and engage in purchases of tax-exempt bearer bonds through foreign nominees in tax havens. The Senate bill may, therefore, increase opportunities for tax evasion by Americans as well as foreigns. (Such a result appears to be far less likely to occur under Rep. Barnard's proposal.)

Finally, the statutory withholding tax plays an important role in our tax treaty negotiation strategy. Our basic treaty policy has three general goals. First, we want to ensure that taxpayers engaged in international transactions pay taxes roughly comparable to the taxes paid by purely domestic taxpayers. Second, we want the revenue collected from taxpayers engaged in international transactions to be shared on some reasonable basis between the country where the income originates and the country where the taxpayer resides. And, third, we want to use the treaty process to obtain information about our own citizens' transactions abroad, so that we can penetrate illegal attempts to shelter income. To achieve these goals, we need the cooperation of foreign tax jurisdictions. Without the leverage provided by our statutory withholding tax, that cooperation will not be forthcoming in many instances.[13]

In conclusion, we believe that repeal of the 30 percent withholding tax, whether completely or in limited fashion, would be a serious mistake. To the extent that repeal would further encourage inflows of foreign capital into the United States, it would increase the exchange rate on the already overvalued dollar, thereby exacerbating an already serious economic problem. Moreover, repeal would turn the United States into a tax haven, a disreputable step that would undermine our ability to get cooperation from other jurisdictions to curtail already existing tax haven abuses.

Proponents of repeal of the withholding tax have brought their case to the Ways and Means Committee before. In 1980, the Committee—wisely, we believe—rebuffed them. This time, we urge the Committee to go further, by directing the Treasury to end the back-door tax-haven route around the withholding tax that is currently being utilized and by setting the withholding rate on Eurobonds at a reasonable level-steps that would both benefit the fairness and integrity of the U.S. tax laws and enhance the vitality of the American economy.

Mr. **Jenkins**. Thank you, Mr. McIntyre.

Mr. Loverd, we will hear from you at this time.

Mr. **Loverd**. If I might ask Mr. Mendoza to start first.

Mr. **Jenkins**. Fine. Mr. Mendoza, we will be glad to hear from you.

STATEMENTS OF ROBERTO G. MENDOZA, EXECUTIVE VICE PRESIDENT, MORGAN GUARANTY TRUST CO. OF NEW YORK, AND ROBERT L. LOVERD, MANAGING DIRECTOR, FIRST BOSTON CORP.

Mr. **Mendoza**. My name is Roberto G. Mendoza. I am an executive vice president of Morgan Guaranty, responsible for the corporate finance activities of the bank.

I am grateful for the opportunity to appear before this committee today on behalf of First Boston and Morgan Guaranty, who are two leading underwriters of U.S. corporate securities in the domestic and international markets.

We support a narrow repeal of withholding tax on portfolio interest payments to foreigners as the best method for preserving and broadening access to the international capital markets by all U.S. borrowers, including the Treasury and entities such as FNMA and smaller companies.

The narrow form of repeal would eliminate withholding tax only on targeted issues, that is to say the issues which are subject to certain constraints to ensure that they are sold only to foreigners, while the broad form of repeal, as in the Senate bill, would totally eliminate withholding tax on interest payments to foreigners and all debt securities, however acquired, including the $2 trillion of existing domestically issued securities.

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[13] The Treasury Department, which we are sorry to see supporting repeal of the withholding tax, has frequently testified about the value of using negotiated reductions in withholding taxes as a bargaining chip in treaty negotiations to obtain better information exchanges with foreign countries, as well as reciprocal reductions in foreign taxes on American citizens. *See, e.g.*, Statement of David Rosenbloom, International Tax Counsel, Hearings on Offshore Tax Havens, Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 96th Cong., 1st Sess. 272, 314–15 (April 1979).

The narrow form of repeal, which is obviously a compromise among the various versions that have been discussed here this morning, is in our view the best solution, for the following reasons.

First, a narrow repeal will increase tax revenues by the greatest amount. Our recommended solution will eliminate the revenue loss due to the use of Netherlands Antilles finance vehicles. Our proposal is limited to targeted new issues.

The broad Senate version, on the other hand, will eliminate withholding on currently outstanding, as well as future issues of domestic securities. It is simply not necessary to eliminate all withholding tax on interest payments to foreigners to preserve access.

We estimate that the narrow repeal would increase tax revenues by at least $875 million over the next 6 years compared to the broad form of repeal. We feel that this is a conservative estimate, given the Treasury estimates that were given this morning.

Second, narrow repeal will provide the broadest form of access for all U.S. issuers. Under the narrow version, all U.S. borrowers, including the Treasury, agencies, and large and small companies, will be able to access the international capital markets at will. The critical difference between the narrow and broad versions is that under the Senate bill foreign investors would have the ability to purchase currently outstanding and future domestic issues on a tax-free basis.

Foreign investors prefer to invest in the best-known, largest companies, and the broad version would decrease the access of smaller companies to international capital. Under the narrow version, these smaller companies would have greater access because they would not have to compete with a huge amount of currently outstanding securities in the domestic market.

Furthermore, under the broad version a number of medium-sized companies who currently enjoy access to the Eurobond market would be forced back into the domestic market because foreign investors would choose to invest in the outstanding domestic issues of the U.S. Treasury and U.S. corporations.

This greater competition for domestic funds will increase the overall borrowing costs of small business, those small companies that under no circumstance would have access to international capital.

Third, the narrow version would minimize the strengthening impact on the U.S. dollar due to tax-free access to the U.S. debt markets by foreigners. Among all of the evidence that we have heard today, no one has disputed the fact that a broad form of repeal would strengthen the dollar. The only question is by how much.

The strength of the U.S. dollar over the past 4 years has tended to make U.S. exports less competitive in world markets. As a result, we have experienced a reduction in exports and reduced U.S. employment. A strong U.S. dollar has contributed to large trade deficits for the United States, rising from $36.4 billion in 1982 to an estimated $110 billion in 1984. According to the Department of Commerce, each $1 billion of lost exports represents 25,000 lost jobs.

Significantly, during this period the U.S. has received substantial capital inflows. At the same time, Germany and Japan, with large trade surpluses, have been the source of large capital outflows. To some degree, the U.S. dollar is kept too strong because foreign investors invest part of their trade surplus proceeds in U.S. dollar markets.

No major industrialized country, and certainly not Germany and Japan, provides completely tax-free access to its domestic securities market by foreigners. As a generalization, most major industrialized countries provide international market access to official and private borrowers, which is broadly similar to the structure which would be created by a narrow repeal of the U.S. withholding tax.

Unilateral broad repeal therefore makes little sense from an economic standpoint, since it could only serve to strengthen the U.S. dollar further.

I would add that the discussion that occurred this morning concerning the zero rates of withholding in various countries may be a little bit misleading. In fact, most countries have a withholding tax which is reduced by treaty to zero or to some other percentage. That applies to Canada, France, the United Kingdom, Germany, the Netherlands, Japan, Switzerland, Italy, Spain, and Belgium.

Those countries which reduce the withholding tax to zero by virtue of a tax treaty with the United States to deal with the equity point of U.S. investors in those markets, the reverse is also the case. They are equivalent to each other. The point that is serious is, what happens to the nontreaty countries?

Fourth, narrow repeal would minimize TEFRA compliance problems relative to broad repeal. For broad repeal to prove effective in encouraging foreign investment would require that foreigners not only be free of withholding, but also be exempt from complying with Internal Revenue information reporting requirements.

This would greatly increase the potential for tax evasion by U.S. persons. The resulting revenue loss would prove serious and lead to future corrective measures to solve the tax evasion problem. In short, the broad—future corrective measures to solve the tax evasion problem, but at the same time restrict access.

In short, the broad form of repeal may create unintended problems simply because it is broader than necessary to achieve the stated objective of preserving and enhancing access. Narrow repeal would achieve the stated objective without creating the potential for additional tax evasion.

Finally, narrow repeal would permit U.S. issuers to finance at a lower rate than under broad repeal. The final point is perhaps the most telling argument in favor of narrow repeal. Under the narrow form, we believe that U.S. issuers, including the Treasury, could finance at a lower rate than under the broader Senate bill.

The evidence in support of this view is overwhelming. The narrow form of repeal would permit issuers to continue to take advantage of the average 50 to 75 basis point savings recently available in the Eurobond market. The Senate bill would severely diminish or totally eliminate these savings, because foreign investor demand could be satisfied by the huge existing pool of domestic securities, thus depriving Eurobond issues of their uniqueness. The broad form of repeal could provide a windfall gain to foreign investors, at the expense of U.S. borrowers.

In summary, we believe that these arguments represent a compelling case for the narrow form of repeal. The narrow solution appears to satisfy the legitimate objectives of all the interested constituencies, and we respectfully urge its adoption.

Thank you.

Mr. **Jenkins**. Thank you, Mr. Mendoza.

Mr. Loverd.

Mr. **Loverd**. Thank you. My name is Robert Loverd and I am the managing director of First Boston. I would like to add several brief comments to those of Mr. Mendoza, with which First Boston concurs.

Thus far and during the course of the balance of this afternoon, you will hear testimony supporting four different versions of withholding tax legislation. The gentlemen from the Netherlands Antilles wish to preserve the status quo. Representative Barnard would allow corporations to borrow overseas on a withholding tax-exempt basis, but favors excluding the Treasury from international capital markets. The SIA, I believe will urge removal of U.S. withholding tax on foreign purchases of any outstanding or future issued domestic security.

First Boston and Morgan Guaranty favor a compromise approach which would allow access to international capital markets by all American borrowers, including the U.S. Treasury and such entities as FNMA and GNMA. Our objective is to put American borrowers in the driver's seat when it comes to selling new issues which raise new funds to support new investments, to generate new jobs.

The targeted approach achieves these objectives. On the other hand, the broad approach puts overseas investors in the driver's seat. Why? It allows them to determine which of the $2 trillion of outstanding domestic securities to purchase at any point in time.

You have heard today and I am sure will continue to hear divergent views on scenarios which might unfold under the broad version. Those testifying are sincere in their views. So how do we explain the differences of opinions?

The answer is quite simple: There is no dependable means of predicting the shape of international financial markets under the broad version. A wide variety of scenarios could unfold, with varying impacts on access to capital, on interest rates, and on the strength of the dollar.

In a sense, therefore, the broad version is a step into the unknown, a world which we cannot predict and may not like. On the other hand, there has been little discussion of what markets will be if the narrow version is enacted. Why? Because it is predictable and it will be stable.

We are also concerned about the increased volatility of interest and foreign exchange rates under the broad version. Historically, the largest non-U.S. purchasers of domestic debt instruments have been foreign central banks. Contrary to the thesis of Paul Erdman's famous book, "The Crash of 1979," central banks have proven to be stable investors.

However, the broad version will attract mostly retail investors, who are driven by currency as well as interest rate considerations. They purchase and sell securities massively and suddenly. The implications for stable markets are obvious.

In summary, we believe that the arguments set forth by Morgan Guaranty and First Boston present a compelling case for the narrow form of repeal. It is a logical, sensible, compromise solution, and we strongly urge its adoption.

Thank you.

[The prepared statement follows:]

STATEMENT OF ROBERT L. LOVERD, MANAGING DIRECTOR, THE FIRST BOSTON CORP., AND ROBERTO G. MENDOZA, EXECUTIVE VICE PRESIDENT, MORGAN GUARANTY TRUST CO. OF NEW YORK

SUMMARY

Access to the Eurobond market free of U.S. withholding tax is critical. Closing off or impeding access would have a substantial negative impact on the U.S. economy. The issue before today's hearing is how best to provide unimpeded access to the Eurobond market. There are basically four ways in which unimpeded access can be preserved:

Continuation of the Netherlands Antilles finance subsidiary mechanism with rules that allow a tax credit for the Netherlands Antilles taxes paid by such subsidiaries;

Elimination of U.S. withholding tax on interest paid to non-U.S. persons by U.S. corporate issuers only, thereby preserving the status-quo;

Elimination of U.S. withholding tax on interest paid to non-U.S. persons, whether on obligations issued by U.S. corporations, the Treasury, or other domestic entities such as FNMA, but *only* with respect to obligations (i) specifically targeted for sale exclusively to non-U.S. persons and (ii) which are sold under procedures designed to ensure that U.S. persons will not purchase such obligations (the "narrow" compromise approach); and

Elimination of U.S. withholding tax on all interest paid to non-U.S. persons (the "broad" approach).

We agree with the Securities Industry Association that a legislative exemption from the withholding tax ought to be available to all borrowers, both public and private. We also agree that until there is such an exemption, Congress should not indirectly cut off access to the Eurobond market by enacting rules that deny a credit for the Netherlands Antilles tax paid by finance subsidiaries. Unlike the SIA, however, First Boston and Morgan Guaranty strongly urge adoption of the narrow compromise approach. Compared to the current Senate version (after the phase-out of withholding by July 1, 1988), the narrow approach:

Would reduce borrowing costs for the U.S. Treasury and for U.S. industry;

Would have a considerably less strengthening impact on the U.S. dollar (thereby avoiding the risk of higher trade deficits and of higher employment);

Would not entail relaxation of enforcement mechanisms enacted in TEFRA;

Would generate more revenue for the Treasury;

Is consistent with structures in other nations and will produce no windfall gain for foreign investors;

Would not increase the volatility of financial markets;

Would not reduce the amount of capital available to our financially weaker allies; and

Would favorably impact the borrowing costs of American small businesses.

STATEMENT

Mr. Chairman, my name is Robert L. Loverd and I am a Managing Director of The First Boston Corporation ("First Boston"). With me is Roberto G. Mendoza who is an Executive Vice President of Morgan Guaranty Trust Company of New York ("Morgan Guaranty"). We appreciate the opportunity to appear today before the Committee on Ways and Means.

Importance of access

First Boston and Morgan Guaranty believe that it is imperative that access to the Eurobond market for U.S. issuers be preserved. The importance of continued access to the Eurobond market for American issuers stems from the extraordinary growth of that market and its increasing use as a source of debt financing for U.S. corporations. Between 1978 and 1982 alone, the amount of debt capital raised by U.S. issuers in the Eurobond market grew almost ten-fold, from $1.5 billion to $14.5 billion. In 1983, the capital raised fell to $7.5 billion, but it has rebounded to an $18 billion annual rate during the first quarter of 1984. Overseas capital has accounted for as much as 28% of total funds raised by American corporations in recent years; thus, foreign investors are now an integral source of funds for U.S. borrowers.

Alternative means of access

Conceptually, there are four broad means of preserving and in certain cases enhancing access to foreign capital:

U.S./Netherlands Antilles Treaty.—Historically, American private sector borrowers established Netherlands Antilles subsidiaries to issue Eurobonds on a withholding tax-exempt basis. For what we understand to be policy reasons, American public sector borrowers have elected not to employ such subsidiaries and therefore have been denied direct access to overseas capital markets. While the satisfactory renegotiation of the U.S./Netherlands Antilles protocol would be an acceptable means of providing access for all private sector American borrowers, we have received no assurance that it will be accomplished. Moreover, we understand that Congress and the Treasury prefer a direct access solution.

Limited access.—Withholding tax exemption could be provided for interest paid by U.S. corporations but not the Treasury. This solution would permit direct access to overseas investors on a withholding tax-free basis without the necessity of special purpose financing vehicles but would limit such access to private sector borrowers.

Narrow access.—A withholding tax exemption could be provided for interest paid by all borrowers, both public and private but only with respect to obligations (i) specifically targeted for sale exclusively to non-U.S. persons and (ii) which are sold under procedures designed to ensure that U.S. persons will not purchase such obligations. This is the approach which First Boston and Morgan Guaranty support. It would permit all American public and private sector borrowers to issue Eurobonds on a withholding tax-free basis without requiring special purpose finance vehicles, but would require such offerings to be sold solely outside the United States under procedures designed to ensure their purchase exclusively by non-U.S persons.

Broad access.—This approach, which is set forth in Gibbons-Conable (H.R. 3025), would enable all outstanding and future issued domestic American securities to be purchased by foreign persons on a withholding tax-free basis. The bill passed by the Senate would impose the broad approach once the phase out of withholding is completed in July 1988.

Concerns about the House and Senate bills

The Tax Reform Bill of 1984 (H.R. 4170) as passed by the House (the "House Bill") and the Deficit Reduction Tax Bill of 1984 as passed by the Senate (the "Senate Bill") would impair access to overseas capital markets for the vast majority of U.S. corporations unless accompanied by an immediate repeal of the 30% withholding tax on offerings sold solely outside the United States. Because of the resourcing rules in both Bills, U.S. corporations borrowing through Netherlands Antilles finance subsidiaries would generate substantial Netherlands Antilles tax liabilities which could not be credited against their U.S. tax liabilities.[1] Although the Senate Bill contains a withholding tax repeal provision which would re-establish access when fully phased in, such phase-in would not occur until July 1988. Thus, we believe that action must be taken in Conference to assure continued access to overseas investors on the part of American borrowers.

The First Boston and Morgan Guaranty position

We believe that the broad version of withholding tax repeal, by making available to foreign investors all outstanding U.S. debt instruments free of U.S. withholding tax, will dilute the benefit of U.S. issuers' access to overseas capital, may unfavorably affect the U.S. balance of trade, and will significantly increase opportunities for tax evasion by U.S. persons. Accordingly, we advocate eliminating withholding only in respect of interest paid on Eurobond offerings (i) specifically targeted for sale exclusively to non-U.S. persons and (ii) sold pursuant to current procedures designed to ensure that securities are not purchased by U.S. persons. A narrow withholding exemption of this type would preserve access to the Eurobond market for U.S. corporations, would provide withholding tax-free access for the first time to the Treasury and other borrowers such as the Federal National Mortgage Association, would raise substantially more tax revenue than the broader version, and yet would minimize the risks associated with a broad repeal of withholding tax.[2]

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[1] Section 128 of the Senate bill and section 141 of the House bill.

First Boston and Morgan Guaranty believe that this narrow compromise approach will be entirely sufficient both to preserve access to the Eurobond market for U.S. corporate issuers and the Treasury, and to do so at considerably lower cost than had the same financings been completed domestically. We prefer the narrow compromise version for eight reasons:

1. The narrow version will reduce borrowing costs for the U.S. Treasury and will preserve a source of lower cost funding for American industry.
2. The broad version will result in substantial additional net capital inflows, which may create a stronger dollar, exacerbate our balance of trade deficit and increase domestic unemployment.
3. The broad version could potentially facilitate tax evasion. The narrow version, on the other hand, would utilize the current restrictions enacted in TEFRA which are designed to assure tax compliance by U.S. persons.
4. The narrow version will generate at least $875 million more revenue over the next six years.
5. The narrow version is consistent with withholding tax structures of virtually every major industrialized nation in the world. The broad version would result in significant ongoing windfall benefits for foreign investors.
6. Unlike the broad version, the narrow version would not increase the volatility of financial markets.
7. The broad version would reduce the capital available to some of our financially weaker allies.
8. The narrow version would tend to have a favorable impact on the borrowing costs of American small businesses.

The remainder of our testimony will elaborate on the foregoing advantages of the narrow over the broad version.

1. Treasury and corporate borrowing costs.—The narrow version would be preferable to the broad approach because it would permit both the Treasury and U.S. corporations to obtain maximum savings on new borrowings.

The narrow version would provide access by the Treasury to overseas investors as frequently as desired and at substantial savings in comparison with prevailing domestic interest rates. Furthermore, it would afford the Treasury access to the Eurobond market without having to compete against the vast quantity of currently outstanding domestic corporate and Treasury securities. For instance, it is our view that in today's market the Treasury could complete a five-year fixed rate issue at a cost of between 25 and 50 basis points below the yield on currently outstanding five-year Treasury obligations. If, over time, the Treasury were to issue targeted Eurobonds frequently and in size, its cost differential between the domestic and Eurodollar markets would narrow. We expect, however, that the yield differential would disappear only gradually, if at all.

The broad approach, on the other hand, would open up to foreign investors, on a withholding tax-free basis, the entire domestic secondary governmental and private securities markets. Such a broad and unprecedented opening of domestic markets would sharply reduce the meaningful cost-of-money savings on new issues referred to above because the new capital inflows would be spread across the nearly $2 trillion of outstanding Treasury and corporate securities rather than channeled into new issues only. Therefore, under the broad withholding exemption, it is extremely unlikely that the Treasury's funding costs would be reduced in any significant way. At the same time, we would expect that (i) those corporations which have in the past borrowed in the Eurobond market would experience a material increase in their funding costs, and (ii) all domestic private sector borrowers, particularly small businesses, would be obliged to pay higher rates of interest than would otherwise be the case. A broad withholding exemption also would benefit foreign investors, who would in the future be able to invest in high-yielding U.S. domestic securities. This would be accompanied by a barely perceptible downward movement in Treasury borrowing costs. Only a narrow targeted Eurodollar exemption would allow the Treasury and U.S. corporations to generate maximum savings on future offerings.

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[2] Hereinafter, reference to financing by the Treasury will also include that by various agencies.

Indeed, the only clear beneficiary under the broad approach would be foreign investors who would be able to invest in U.S. domestic securities at significantly higher yields than are currently available for comparable investments outside the United States. For instance, Citicorp, General Electric Credit and General Motors Acceptance Corporation each have outstanding domestic bonds maturing in 1990 which are presently yielding between 13.15% and 13.40%, while their outstanding Eurobonds maturing that same year yield between 12.05% and 12.60%. Under the broad version, sophisticated overseas investors would enhance their investment returns by selling the outstanding Eurobond issues and purchasing their domestic equivalents. This arbitrage opportunity would obviously make it impossible for those companies to raise funds in Europe in the future at interest rates which are below domestic rates.

2. Balance of trade and unemployment.—Under the broad version, the wide variety of high quality, high-yielding securities available in the U.S. domestic market could induce a major flow of capital into the United States. To the extent that these inflows are attributable to the sale of foreign currency instruments, this increase would drive the value of the dollar higher, thereby reducing the cost competitiveness of U.S. exports and increasing the inroads made in U.S. markets by imports, especially from Japan. This, in turn, would probably translate into higher domestic unemployment, with U.S. manufacturers forced to curtail output, investment, and employment as a result of being less competitive both domestically and abroad.[3]

The harmful effects of a negative trade balance on the economy of the United States were recently testified to before this Committee's Subcommittee on Trade by a group of chief executives speaking on behalf of the Business Roundtable. In noting that in February the United States imported $10 billion more in goods and services than it exported, the Chairman of Caterpillar Tractor Co. testified that he could not "think of any word other than 'devastating' to describe the impact of that kind of trade performance on the U.S. industrial sector." The March trade deficit was also recently reported at over $10 billion, so that forecasts for the full year of a massive $100 billion trade deficit may prove too low. The table on page 9 shows the scale of U.S. long-term capital inflows which have helped provoke the strength of the dollar and a consequent negative trade balance.

SELECTED BALANCE OF PAYMENTS ITEMS

[Dollars in billions]

	Current account	Of which: Trade	Selected capital items[1]
United States:			
1982	−$11.2	−$36.4	$35.2
1983	−41.0	−60.0	32.9
1984[2]	−75.0	−100.0	n.a.
Japan:			
1982	6.9	18.1	−15.0
1983	21.0	31.6	−17.8
1984[2]	24.7	36.0	n.a.
Germany:			
1982	3.5	26.3	−6.7
1983	3.3	21.5	−3.2
1984[2]	5.5	27.3	n.a.

[1] Items that move autonomously, generally long-term; the total capital account is necessarily equal and opposite to the current account.
[2] Morgan Guaranty forecasts.

On the other hand, if the withholding tax exemption were restricted to targeted Eurodollar issues, the economic consequences would be substantially the same as under the current Netherlands Antilles finance subsidiary borrowing structure. Considering both the existing economic situation and the present upward pressure on the dollar as interest rates rise in response to the conflict between the budget deficit and increasing private demand for credit, the broad appeal of withholding tax could hardly have been proposed at a worse time.

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[3] As of April 27, 1984, the dollar, on a trade-weighted basis, has appreciated by 33.2% from its low point in July 1980. In real terms, i.e., removing the effects of relative inflation, the dollar has appreciated 29.2% over the same period. This is the best measure of the decline of U.S. industrial cost competitiveness at home and abroad.

3. Potential tax evasion by U.S. persons.—Enactment of the broad withholding exemption will have adverse tax policy as well as economic implications. Indeed, in certain respects it will go far toward undoing the tax enforcement mechanisms embodied in both TEFRA and the Interest and Dividend Tax Compliance Act of 1983 and will create a gap in the information reporting system which TEFRA was intended to close.

If withholding on any registered obligation is eliminated upon receipt of a statement that the obligation is owned by a foreign person, then it will be possible for U.S. persons to evade entirely any U.S. tax on such interest by utilizing an entity in a tax haven which would provide false beneficial ownership certificates to certified paying agents. The Senate Finance Committee Report on the Senate Bill makes clear (on page 422 of the report) that such a statement need not even disclose the name of the beneficial owner. The opportunity for complete U.S. tax evasion stems from the fact that, as recent experience in the Eurobond market makes abundantly clear, access to foreign capital will be preserved under the broad proposal only if the provisions of the Internal Revenue Code governing information reporting and 20% back-up withholding are also amended to exempt from these requirements any interest which is exempt from 30% withholding at source. These amendments, however, when coupled with the basic withholding exemption already contained in the Senate Bill, will for the first time in effect permit U.S. persons to hold registered U.S. securities outside the United States on a non-disclosure basis and avoid U.S. withholding taxes on interest payable on them. The broad exemption, in other words, could effectively insulate the interest received by U.S. tax evaders filing false beneficial ownership certificates from any U.S. taxation whatsoever.[4]

If the withholding tax exemption is limited to specifically targeted Eurobond issues, on the other hand, U.S. issuers would be able to sell their obligations only to the same class of holders which presently purchase the obligations of Netherlands Antilles finance subsidiaries. While it is true that tax evasion by U.S. persons willing to risk incurring the penalties imposed by TEFRA on U.S. persons holding bearer obligations will still be possible, any such potential evasion will be limited to a class of securities marketed under conditions designed to ensure their sale only to foreign persons and, accordingly, will be far more limited in scope than under the broad withholding exemption.

Considerations of tax enforcement, therefore, strongly point to a narrow withholding tax exemption as the preferable means of preserving access to the Eurobond market. If compliance standards are relaxed to accommodate the broad repeal of withholding tax, it is clear that Congressional and Treasury efforts to "reduce the ability of noncomplying taxpayers to conceal income and property from the reach of the income, estate and gift taxes" would be seriously jeopardized.[5] The narrow version eliminates any potential for tax evasion on the nearly $2 trillion of currently outstanding domestic Treasury and corporate securities.

4. Revenue loss.—Another significant advantage of the narrow withholding exemption as compared to the board exemption contained in the Senate bill is that the narrow exemption would raise more revenue than the board version because (i) it would preserve the 30% withholding tax on interest paid on domestically issued securities, and (ii) the broad exemption would in all likelihood raise the overall borrowing costs of U.S. corporations, thereby increasing their interest deductions and reducing their overall tax liabilities. It is our estimate that, compared to the broad withholding exemption, the narrow targeted Eurodollar exemption would raise at least $875 million more revenue over the next six years.

5. Practices of other countries.—The broad withholding exemption would make the United States virtually the only major industrialized nation which imposes no withholding tax on interest paid to foreigners on its domestic securities.[6] In virtually all major industrialized nations, a withholding tax is imposed on interest paid to non-residents with respect to domestic securities, but corporations and governments of such nations can borrow in the Eurobond market on a withholding tax-free basis by issuing targeted Eurobonds. This is true even in the case of countries such as

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[4] While it is true that the Senate bill permits the Secretary of the Treasury to withdraw the qualification of foreign entities to issue such certificates, it is difficult to know how the Secretary would be able to identify the organizations whose qualified status should be revoked. Accordingly, it is highly unlikely that this grant of authority will forestall U.S. tax evasion of the type indicated.

[5] Joint Committee explanation of TEFRA, p. 190.

[6] Holland and certain Scandinavian countries are the only exceptions.

Germany and Japan which, with relatively weak currencies, large capital outflows and trade surpluses, might most appropriately adopt a broad withholding exemption. Accordingly, if the broad withholding exemption is enacted, overseas investors in obligations of U.S. issuers will be afforded a benefit which their countries do not provide to citizens of the United States.

6. Volatility.—Currently, a significant portion of foreign holdings of Treasury securities are in the hands of certain banks which either hold non-negotiable, Treasury securities or in any event would be unlikely to engage in precipitous or disorderly selling of such securities. To a significant extent, new buying of Treasuries under the broad version would come from foreign retail investors who are currency driven. As such, they will tend to purchase and sell U.S. securities massively and suddenly, thereby intensifying the underlying interest rate and foreign exchange rate volatility. Thus, in comparison with the narrow version which allows borrows to funnel foreign investor demand into designated securities, the broad version puts foreign investors in the driver's seat by making available to them the full range of domestic securities.

7. Availability of capital.—To the extent that the broad version induces capital flows from overseas into the United States, foreign sovereign and private sector borrowers would be deprived of funds which would otherwise be available to satisfy their financing needs. While such an effect may be acceptable in normal times, the current environment is far from normal. The already high interest rates and scarcity of international capital have put financial pressure on our allies around the world. If the broad version were enacted, the consequences resulting from America's open-ended absorption of overseas capital could be unfortunate.

8. Impact on borrowing costs of small business.—Those who favor the broad approach believe that small American businesses will get a reasonable portion of the foreign capital flowing freely into the United States, thereby leading to a reduction in their borrowing costs. This is contrary to the well-known and empirically tested view that foreign investors are extremely credit conscious and have refused to purchase the debt securities of smaller companies which are not well known or whose credit rating is less than investment grade. Accordingly, those companies which currently do not access the Eurobond market would still not be able to attract foreign investment funds under the broad version. In fact, if anything, the broad approach would impose further restrictions on which companies could access foreign capital since new issues by small companies would have to compete against the large volume of outstanding higher quality securities. In substance for small corporations broad access to foreign investors is not a meaningful or relevant concept.

Moreover, under the broad version, a number of companies which now enjoy regular access to the Eurobond market would be forced back into the domestic market because foreign investors would channel their funds into the obligations of higher rated companies and the U.S. Treasury. This would increase the reliance of those corporations on funds derived from domestic investors, thereby further increasing the overall borrowing costs of smaller businesses. Thus, under the broad version, small businesses would have less access to foreign capital and would tend to be squeezed by larger corporate borrowers who would be forced back into the domestic market. The narrow version would avoid these problems.

CONCLUSION

For all the reasons listed above, First Boston and Morgan Guaranty believe that an exemption from U.S. withholding tax on interest received by overseas investors is necessary, but that considerations of both economic and tax policy strongly dictate that the exemption be limited to interest on Eurobond issues (i) targeted specifically for sale exclusively to non-U.S. persons and (ii) sold under procedures designed to ensure that no purchases are made by U.S. persons. This narrow compromise approach broadens access to the Euromarket by including such borrowers as the Treasury, but does so without creating the risks and uncertainties inherent in the broad approach.

Thank you for the opportunity to testify.

Mr. JENKINS. Thank you, Mr. Loverd.

We will now hear from Mr. Evans.

STATEMENT OF JOHN C. EVANS, ADVISORY DIRECTOR, MORGAN STANLEY & CO., INC.

Mr. EVANS. Mr. Chairman and members of the Ways and Means Committee, my name is John Evans. I am advisory director of Morgan Stanley & Co., Inc. I greatly appreciate the opportunity you have given me to address the committee on this important issue this afternoon.

Morgan Stanley is now and has been for the past 9 years firmly committed to the repeal of the 30-percent withholding tax on portfolio investors in U.S. bonds by foreigners. What this means is that we favor extending to the more stable, longer term borrowings the exemption that has existed for years with respect to the many times larger amount of less stable short-term borrowings outstanding.

Morgan Stanley, like the 500-member Securities Industry Association of which it is a member, strongly supports the passage of H.R. 3025, the Capital Tariff Repeal Act, sponsored by Congressmen Gibbons and Conable. Morgan Stanley believes that the Gibbons-Conable bill is an important piece of legislation, not just for the financial and corporate communities, but for the American economy in general.

The background of this legislation is known to most of you, so I will only summarize the most important features of the bill and discuss in more detail certain aspects of the current market in dollar-denominated debt. As you know, the 30-percent withholding tax acts as a barrier to foreign investment in U.S.-issued bonds. This has led to an enormous growth in the amount of dollar-denominated bonds issued in the offshore bond market.

The cause of this growth in the volume of U.S. corporate Eurodollar bonds is the prohibitive incremental cost of issuing domestic U.S. bonds to foreigners which the 30-percent withholding tax represents.

As an aside, in response to earlier discussions here, I would like to point out that we are talking here about bonds, which are debts. We are not talking about equities. The capital gains tax on foreign-held real estate applies to equities. We have a withholding tax on dividends on equities, which is not now under discussion here. There is no inconsistency.

The Eurobond market has been discussed in this committee before. I would just like to emphasize that it includes many tax-exempt institutions and other investors in countries that impose no income taxes. Their preference for anonymity predates the invention of the income tax. It stems from an aversion to confiscation, with which they have had considerable experience.

Over the past several years, we have seen a large shift in the focus of borrowing by large U.S. corporations from the United States to Europe. The trend has been so strong that we now see two approximately equal dollar-denominated bond markets in which U.S. corporations may borrow.

The United States also has a persistently low savings rate. These are what set the United States apart from other countries in respect of the legislation under consideration here. This applies to everything that has been said about Japan and possible French retaliation. I repeat, we have an offshore dollar bond market roughly the same size as our domestic market for new issues, and we have a consistently lower savings rate.

While Morgan Stanley and certain other major U.S. investment banking firms have been able to shift operations, to London in order to perform the conduit function for American companies drawing on the Eurodollar capital pool, the shift of the center of gravity from the United States is simply not good for American business, the U.S. Treasury, or the American economy.

The first major point I would like to make is that the Eurodollar pool is not available to American corporate borrowers in the same way as the U.S. capital market. While the latter is naturally free of foreign withholding tax for U.S. investors, the former presently requires the use of a Netherlands Antilles financing subsidiary to make it that way for foreign investors.

Exempting the interest on Eurobonds issued abroad from the 30-percent withholding tax, as proposed by Congressman Barnard, will preserve existing access for certain corporations, while eliminating the need to maintain a financing subsidiary in the Netherlands Antilles. This will maintain present access, but will enhance the growth of the offshore dollar bond market.

The foreign investor will not be any more inclined than he is now to buy the bond of a U.S. company that cannot tap the Eurobond market. The requirement of name recognition, high bond rating and large issue size for U.S. companies borrowing abroad would continue to be a barrier for many U.S. companies in foreign dollar markets.

The importance of the large issue requirement may not be immediately evident, but it is an importance. Large issues are required by investors because they provide active secondary trading markets, without which they would not be interested in the primary issue at the most competitive interest rate.

Therefore, smaller or lesser known companies which cannot do or do not need large Eurobond issues will continue to be totally excluded from the longer term Eurodollar pool. Under H.R. 3025, more sophisticated foreign investors could and would participate in higher yield domestic issues of smaller and lesser known companies.

Outright repeal of the 30-percent tax on bond interest by passage of the Gibbons-Conable bill would also make it unnecessary for U.S. companies to issue Eurobonds, because foreigners would invest directly in domestic American bonds. While Gibbons-Conable would eliminate a privileged status for large U.S. corporations with high bond ratings and international name recognition, it will place all U.S. corporations on an equal tax footing in competition for longer term foreign-held dollars.

Additionally, major beneficiaries of foreign capital that would be permitted into the Unites States by Gibbons-Conable would be the U.S. Treasury and certain U.S. agencies. These entities cannot now sell Eurobonds, nor could they under the Barnard proposal. Foreign direct purchase of the Treasury notes and bonds would not only assist in financing U.S. deficits, but since these funds come at the margin they would tend to lower the Treasury's long-term borrowing costs.

With a reintegrated worldwide dollar bond market, the selection of acceptable borrowers would be determined by market forces, a mechanism which has proved itself, on which our system is based and in which we believe. Therefore, repeal of the 30-percent withholding tax, which will eliminate the barrier to foreign portfolio investment in U.S. bonds, is the most effective, sensible and fair option in addressing the problem of U.S. borrowings of longer term Eurodollars.

My second point is of equal importance and perhaps greater urgency to U.S. business: The necessity for maintaining access to the Eurodollar market. As you know, both Houses of Congress have recently passed legislation, for very good reasons, that would eliminate certain tax credits for foreign taxes paid to tax haven countries. As this legislation is now worded, however, access to the Eurobond market would then depend upon a company's foreign source income position.

As a matter of national policy, this seems to be an irrational way to determine which companies will have access to longer term dollar financing. As a practical matter, only a few multinational corporations will be able to generate the necessary foreign-source income, while some current participants in the Eurodollar market, such as public utilities, will be effectively shut out.

The result would be that virtually all U.S. corporations, the U.S. Treasury, and the U.S. governmental agencies with a need to borrow funds would compete in the domestic capital market for all those funds, without the offsetting benefit of foreign-held dollars on the lending side.

I need not tell this group about the growing Federal appetite for credit, but I will point to the fact that longer term interest rates have surely been mitigated over the past several years by the availability of tens of billions of Eurodollars for certain corporate obligations. Loss of access to these funds would aggravate the crowding-out danger and have a direct upward effect on interest rates. I do sense here, however, that the need to preserve access has become generally recognized in this committee.

Third, the shift of borrowing to the Eurodollar pool has meant a direct loss of jobs in the United States. The jobs lost are those associated with the issuance of bonds. I emphasize that Morgan Stanley, my own firm, and several other firms have built substantial operations in Europe because that is where the Eurobond business is centered owing to the existence of the 30-percent tariff on foreign investment in domestically issued bonds.

If the tax is repealed, the bulk of U.S. corporate Eurobonds currently issued through our European offices will be issued in the United States. We will welcome the opportunity to shift a substantial part of the activity back to our domestic organizations.

This shift alone by the underwriting firms now engaged in this business, not to mention the resulting internationalization of the capabilities of other firms and banks, will directly benefit the U.S. economy.

Many estimates have been made of the revenue impact of the repeal of the 30-percent tax. Some of these are based on the unwarranted assumption that there exist investors in the world who would be exempted by H.R. 3025, but who would pay the tax in some significant amount if it remained applicable to them, or alternatively, U.S. borrowers who would pay it for them.

Such investors and/or borrowers do not exist, and it would be folly to institute resourcing rules in the face of the 30-percent tax in order to find this out the hard way. The shock to our domestic bond market and to our economy that would result from the additional burden of domestic financing would be too high a price to pay for an experiment.

We recognize, however, the importance of tax revenue to this committee, so I will set out in more detail our reasons for believing that repeal of the 30-percent withholding tax will actually produce revenue for the Treasury.

Estimating revenue from repeal of this tax must begin by estimating the amount of revenue currently lost through credits for taxes paid to the Netherlands Antilles against the U.S. tax liability of domestic corporations. We estimate this amount is currently running at about 5 percent of the $40 billion of funds outstanding, or about $200 million a year, and increasing.

As the Netherlands Antilles tax is collected in arrears, the revenue figures of that country will necessarily lag the true rate at which these U.S. tax credits are piling up. In estimating the tax revenue that the Gibbons-Conable bill would cause the Treasury to forgo, we tried to identify a prototype foreign investor who would not only pay his domestic tax, but would also buy U.S. domestic bonds and pay the 30-percent withholding tax, the revenue from which would have to be deducted from the revenue gain resulting from the elimination of the foreign tax credit.

We have been unable to identify, aside from some Canadians, any substantial body of such investors. A similar answer comes from the other leading firms in our industry. This conclusion is not surprising. I think you will agree that such a foreign investor would seem to act irrationally if he would buy, for example, a domestic GMAC bond and pay a 30-percent tax, when there are plenty of tax-free GMAC bonds outstanding in the offshore market.

It has come to our attention that certain foreign banks, for instance in Japan, have paid the U.S. withholding tax on sizable transactions so long as it has been covered by their own foreign tax credits. But of course, these transactions are not exempted by H.R. 3025. The revenue would not be lost, therefore. This and interest to foreign parent companies, also not exempted, should, therefore, be deducted from the revenue gained by withholding.

We reject, incidentally, any claim that purchase of existing bonds from Americans by foreigners would result in a loss of tax revenue. The Americans, of course, would simply reinvest the proceeds and go on paying their taxes.

Our conclusion, assuming that we, as a country, are wise enough not to pay the cost of cutting off access by applying the proposed resourcing scheme to the legitimate issuance of bonds, is that the actual net revenue gain is likely to be in the $150 million range, not counting the secondary effect of lower Treasury borrowing rates. We have seen no evidence today that has caused us to change this estimate.

Finally, as the Treasury has testified, the Gibbons-Conable bill will enable us to know more about where interest payments are going and gives the Treasury authority to reimpose the tax, which functions as a virtually 100-percent effective tariff barrier, on those countries which assist in evasion by U.S. taxpayers.

I would point out that one bad foreign bank, in other words, can put all other banks in the same country, and their clients, out of the U.S. bond business. The pressures for self-policing are, therefore, strong. Of course, neither bill under discussion would make a tax haven out of the United States.

In response to Chairman Rostenkowski's question with respect to the effect on the dollar exchange rate, I would like to state that the currency preference of foreign investors would not be materially affected by their investing directly rather than through targeted issues. Dollar proceeds of bond issues, direct or targeted, simply flow into the United States where we can use them. They do not require transactions across foreign exchanges.

Speculative money which does cross the foreign exchanges goes into short-term obligations, already free of tax, and it is largely already here. There are plenty of these obligations available and plenty is all that is required.

In conclusion, while others have discussed alternatives to H.R. 3025, the Gibbons-Conable bill, it is our belief that no other piece of legislation can be said to match it in fairness or effectiveness in helping to meet the financing needs of this country. We hope there is no confusion about that.

Thank you, Mr. Chairman and members of the committee.

Mr. **JENKINS**. Thank you, Mr. Evans.

Mr. Hyland.

STATEMENT OF JOHN W. HYLAND, JR., CHAIRMAN, INTERNATIONAL COMMITTEE, SECURITIES INDUSTRY ASSOCIATION, AND MANAGING DIRECTOR, BLYTH EASTMAN PAINE WEBBER INC., ACCOMPANIED BY JEFFREY M. SCHAEFER, SENIOR VICE PRESIDENT AND DIRECTOR OF RESEARCH, SECURITIES INDUSTRY ASSOCIATION; AND M. BERNARD AIDINOFF, COUNSEL

Mr. **HYLAND**. Mr. Chairman and distinguished committee members; thank you for the opportunity of appearing today. My name is Jack Hyland. I am the managing director of Paine Webber and chairman of the International Committee of the Securities Industry Association, and it is in that capacity that I appear before you today.

With me are Bernard Aidinoff, a partner of Sullivan & Cromwell, and Jeffrey Schaefer, a senior vice president of the Securities Industry Association.

The SIA represents 500 firms dealing in the securities markets, and representing more than 90 percent of the business. It is our position to support the position taken by the Treasury this morning. We agree with it and we would like to support it, and that is that we favor nondiscriminatory access by U.S. issuers to the international markets, and we strongly, therefore, support the complete and immediate repeal of the 30-percent withholding tax.

Over the past 20 years, a substantial amount of funds, mostly denominated in dollars, have grown up outside the United States, and they exist and have been tapped by, generally, larger U.S. corporations to supplement their funding sources. It is not possible for those corporations to access those funds directly, and the Netherlands Antilles finance companies have provided a means of indirect access.

While continued access to this Eurodollar market may be achieved through a renegotiation of the tax treaty, the SIA believes that the repeal of the 30-percent withholding tax is preferable. The repeal of the withholding tax, as has been made abundantly clear in the testimony you have heard today and will continue to hear, can be accomplished in a number of different ways.

It is our opinion that the Gibbons-Conable bill, H.R. 3025, is the preferable alternative. Through this act, it would be possible for all U.S. issuers to access foreign capital sources. There is this opportunity which we think is an important aspect of the internationalization of the U.S. markets and of accessing capital at a time when it is extremely important for corporations, financial institutions, Government agencies, and Treasury.

Under Gibbons-Conable, direct access would be provided to corporations, small or large, to financial institutions, to the Treasury, and to the agencies. The Barnard bill, as has been stated, is more targeted and limited to specific issues outside the United States.

Neither the proposed Gibbons-Conable nor the Barnard bill would, in our opinion, result in avoidance of U.S. income taxes by U.S. persons. Each of the bills contains restrictions carefully worked out with the Treasury Department to provide adequate provisions for the exchange of information.

The TEFRA restrictions on the sale of bearer obligations to U.S. persons are incorporated in both proposed bills. The amount of funds accruing to the Treasury from those no longer to be paid to the Netherlands Antilles tax authorities would work on approximately an equal basis in the case of both bills.

Finally, the SIA sees no justification for phasing in elimination of the 30-percent withholding tax over a 4-year period. A complete repeal of the withholding tax will encourage those companies which have used Netherlands Antilles finance subsidiaries to assume the debt, which will result in higher income to the U.S. Treasury.

If the withholding tax is phased in, the SIA would recommend that section 141 of H.R. 4170, which results in recharacterization of income, is delayed until the end of the phase-in period.

Finally, the Securities Industry Association supports the outright repeal of the 30-percent withholding tax. If outright repeal is not decided upon, then we would recommend that the Barnard proposal be implemented to continue to preserve access to the Eurodollar market by U.S. issuers.

Thank you.

[The prepared statement follows:]

STATEMENT OF JOHN W. HYLAND, JR., CHAIRMAN, INTERNATIONAL COMMITTEE, SECURITIES INDUSTRY ASSOCIATION

My name is John W. Hyland, Jr. I am a Managing Director at Blyth Eastman Paine Webber Inc. and Chairman of the International Committee of the Securities Industry Association. It is in this latter capacity that I appear today. With me are Jeffrey M. Schaefer, Senior Vice President and Director of Research of the Securities Industry Association and M. Bernard Aidinoff, a partner in the law firm of Sullivan & Cromwell. Goldman, Sachs & Co., Merrill Lynch Capital Markets, Morgan Stanley & Co., Incorporated, and Salomon Brothers Inc participated in the preparation of this statement.

The Securities Industry Association represents over five hundred leading investment banking and brokerage firms headquartered throughout North America which collectively account for more than 90% of all securities business in North America. Because of their role in world capital markets, SIA members are in a unique position to assess the impact of tax policy on the Eurobond market.

We appreciate this opportunity to appear before the Committee on Ways and Means. Our principal objective in appearing here today is to testify in favor of both the preservation of access for United States corporations to the Eurobond market and the broadening of such access to all United States borrowers. We believe that the best way to achieve this objective is through the enactment of H.R. 3025, the Gibbons-Conable bill, which would eliminate the 30% withholding tax on interest paid to foreign investors in debt securities of United States corporate and governmental issuers. Because of the statutory exemption with respect to interest on bank deposits and the limited application of withholding to commercial paper, there is usually no withholding tax on interest paid to foreigners who lend money on a short term basis to United States entities.

In our testimony, we will focus on the following:

(1) While we recognize that access to the Eurobond market may be achieved through the continuation or the renegotiation of a tax treaty with the Netherlands Antilles, repeal of the 30% withholding tax is clearly preferable from a public policy perpective since a repeal will significantly expand access to overseas investors on the part of United States borrowers.

(2) Repeal should be immediate and not, as under Section 142 of the Senate bill, phased in over a period of years. No sound tax policy justifies a phase in.

(3) Unless there is an immediate repeal of the 30% withholding tax, we strongly oppose the extension to finance subsidiaries of measures, such as Section 141 of H.R. 4170 and Section 128 of the Senate bill that would treat as United States source income any distributions and interest payments received by a United States person from a "United States owned foreign corporation" which derives a certain portion of its income from United States sources and thereby make use of the Eurobond market by United States corporations totally uneconomic.

1. Repeal of the Withholding Tax.—Under current law, the United States imposes a withholding tax at a 30% rate on interest payments made to foreign investors. Although the 30% rate may be reduced by existing tax treaties, such treaties, as a practical matter, are not relevant for debt obligations publicly offered outside the United States to foreign nationals.

Debt obligations of United States issuers, burdened with this tax, compete with other securities sold outside the United States by non-United States issuers which are free of any withholding tax. The net effect of the United States withholding tax, in most cases, would be to reduce the return to overseas investors on interest bearing securities issued in the United States by up to 30%. This reduced return would make United States government and corporate obligations noncompetitive with alternative investments available in the Eurobond market. While it is theoretically possible to increase the yield so as to cover the United States withholding tax, this makes the Eurobond market considerably more expensive than the domestic market and unattractive to United States issuers which bear the additional cost. As a practical matter, debt securities subject to the 30% withholding tax are not purchased by foreign private sector investors.

United States corporations seeking to borrow in the Eurobond market have done so through special purpose finance subsidiaries, typically incorporated in the Netherlands Antilles. Netherlands Antilles finance subsidiaries have been employed for this purpose ever since the imposition of the Interest Equalization Tax more than 20 years ago. In fact, the original utilization of Netherlands Antilles finance subsidiaries was encouraged by the United States Treasury. During the past several years, the Eurobond market has grown enormously. Funds raised by United States corporations in this manner amounted to $7.5 billion in 1983, $14.6 billion in 1982, $6.8 billion in 1981, and $4.4 billion in 1980, up from $.2 billion in 1974; almost $40 billion of such issues have been completed by United States corporations since 1974.

We believe that continued access by United States borrowers to the Eurobond market is of significant interest to this nation's financial health. If a suitable means of accessing the Eurobond market free of United States withholding tax were not available, overseas capital markets would be closed to future offerings by United States corporations with the following possible consequences:

(1) The United States domestic capital market would experience increased pressure.[1] For example, had the $7.5 billion of Eurobond issues completed during 1983 been sold instead in the domestic market, new issues in the latter market would have been increased 16% from $47.3 billion to $54.8 billion. We believe that this increased supply could only have been absorbed at some higher level of interest rates. During recent years, overseas markets have functioned as a pressure release valve.

(2) As many United State corporations which financed in the Eurobond market during recent years were of high credit quality, their return to the United States capital markets would tend to squeeze lower quality issuers out of the United States domestic market.

[Dollars in billions]

	(1)[1]	(2)[2]	(3)[3]
1980	$4.4	$41.6	10
1981	6.8	38.1	15
1982	14.6	43.8	25
1983	7.5	47.3	14

[1] Eurobond and foreign currency borrowing by U.S. corporations in foreign markets.

[2] Public corporate debt offerings in the U.S. market.

[3] 1 plus 2 equals 3; percentage of foreign market borrowings to total borrowings.

(3) The increase in the private sector's domestic funding activities would conflict with those of the United States government as it attempts to finance its budgetary deficit.

(4) It is highly unlikely that any significant portion of overseas investment funds which would otherwise have been employed for the purchase of Eurobond obligations of United States corporations would find their way back to the United States. While a portion of such funds might be temporarily deposited in U.S. banks, they would ultimately be invested in debt obligations of those non-United States issuers which have free access to international capital markets.

We recognize that a continuation of the existing Netherlands Antilles tax protocal would permit United States corporations to continue to borrow in the Eurobond market. However, there are several tax policy objections to making access to foreign capital depend on the use of finance subsidiaries. First and most important, because of the foreign tax credit allowed for the Netherlands Antilles income tax, the use of Netherlands Antilles finance subsidiaries involves a substantial annual cost to the United States Treasury. Secondly, the current situation is subject to uncertainty because of both the renegotiation of the tax protocol between the United States and the Netherlands Antilles and recent Internal Revenue Service challenges to the tax status of certain Netherlands Antilles subsidiaries. And, lastly, the current situation discriminates among issuers since it excludes United States issuers which are unwilling or unable to set up Netherlands Antilles finance subsidiaries.

We strongly support H.R. 3025 which would generally repeal the 30% withholding tax on interest paid to foreign persons on portfolio indebtedness. Such legislation, by making the continued use of Netherlands Antilles finance companies unnecessary, would raise up to $150 million in tax revenues each year, an amount which more than justifies the inclusion of repeal in the tax bills now pending in Congress. The $150 million a year represents our estimate of the amount of tax now paid to the Netherlands Antilles on outstanding Eurobond issues and does not take into account any growth in the Eurobond market. We believe that if the Gibbons-Conable bill were enacted, United States corporations would assume outstanding Eurobonds issued by Netherlands Antilles finance subsidiaries, thus eliminating the foreign tax credits claimed for Netherlands Antilles income taxes in respect of such borrowings.

Passage of Gibbons-Conable would not only preserve existing access by United States corporations to foreign capital in a simple and straightforward manner but also would significantly broaden and enhance foreign investors' ability to purchase newly-offered debt securities of all United States borrowers, including those of the United States government and of instrumentalities and agencies of the United States government, as well as outstanding debt securities of all United States issuers. As United States government obligations and domestically-issued corporate securities would become competitive with securities offered in the Eurobond market, the distinction between the United States domestic and Eurobond markets would tend to decline resulting in a shift of the center of global capital markets back toward the United States.

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[1] This table illustrates the importance of foreign capital markets as a source of financing for United States corporate borrowers.

Enactment of H.R. 3025 will not increase tax noncompliance by United States persons. Based on 20 years of experience in marketing Eurobonds, we have every reason to believe that very few, if any, of those obligations fall into the hands of United States persons, that United States persons are generally not interested in purchasing Eurobonds issued by United States corporations, especially after TEFRA, and that the purchasers of these obligations in both the primary and secondary markets are, in fact, foreign persons. Additionally, H.R. 3025 was carefully drafted with the Treasury Department in order to ensure tax compliance through provisions for the exchange of information and incorporation of the TEFRA restrictions on the sale of bearer obligations to United States persons.

The Gibbons-Conable bill does contain narrow exceptions to the rule which eliminates the 30% withholding tax on interest paid to foreign persons. While we understand the policy considerations underlying the exceptions for loan interest received by a bank in the ordinary course of a banking business and for interest received from certain related parties, we believe that the exception for interest received by a controlled foreign corporation is unnecessary. This exception will merely encourage controlled foreign corporations to invest in Eurobond obligations of foreign issuers.[2]

Furthermore, any concern that controlled foreign corporations would invest in obligations of United States issuers yielding United States source income only to have such income become foreign source income for foreign tax credit purposes when it is returned to the United States is effectively taken care of by Section 141 of H.R. 4170.

If the Gibbons-Conable bill is enacted, the current rules regarding the application of information reporting and backup withholding to obligations issued by United States corporations to foreign investors must be revised. As currently drafted, neither Section 6049, the regulations thereunder, nor the regulations under Section 3406 contemplate the application of interest reporting, and therefore backup withholding to these obligations. Section 6045, the regulations thereunder, and the regulations under Section 3406 would require a foreign holder of an obligation to identify himself by providing the paying agent with a Form W-8 in order to avoid backup withholding at the time the obligation is redeemed. Any requirement that the foreign holders of obligations identify themselves in order to avoid backup withholding would seriously interfere with the marketing of new obligations.

We believe that this problem could be solved by treating bearer obligations issued by United States corporations in the Eurobond market in the same way that bearer obligations of Netherlands Antilles finance subsidiaries are now treated. Thus, interest and principal paid on such obligations outside the United States would be exempt from information reporting and backup withholding and foreign holders would be required to identify themselves only if payment of interest or principal was made within the United States. In the case of registered obligations, we believe that the statement described in Section 1(b) of the Gibbons-Conable bill (proposed Section 871(g)) should suffice to establish that the beneficial owner is not subject to backup withholding.

Like the Gibbons-Conable bill, H.R. 4029 introduced by Representative Barnard, would remove the 30% withholding tax on bearer United States corporate obligations targeted for sale exclusively to foreign persons and would thereby eliminate the need for the utilization of Netherlands Antilles finance subsidiaries. H.R. 4029 is merely a narrower version of Gibbons-Conable in that it is limited to bearer issues specifically targeted for the Eurobond market. We believe that H.R. 4029 would also raise up to $150 million in tax revenues each year because of the elimination of the foreign taxes attributable to the Netherlands Antilles and it is similar to Gibbons-Conable with respect to tax compliance. However, H.R. 4029 would not broaden or allow equal access to foreign capital by all United States issuers of debt securities as does Gibbons-Conable.

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[2] Congress has in the past, recognized that it is unwise to encourage controlled foreign corporations to invest solely outside the United States. Prior to amendment by the Tax Reform Act of 1976, Section 956 of the Internal Revenue Code treated any investment by a controlled foreign corporation in the stock or obligations of any United States person as a taxable distribution to the United States shareholders of the controlled foreign corporation. After admitting that this provision was too broad and induced controlled foreign corporations to purchase foreign rather than United States obligations, Congress amended Section 956 to treat only investments in the stock or obligations of United States shareholders or a United States corporation in which United States shareholders own 25% or more of the stock as a taxable distribution. H. Rpt. 94-658, 94th Cong., 1st Sess. p. 216 (1975); S. Rpt. 94-938, 94th Cong., 2d Sess. p. 225-27 (1976).

While both Gibbons-Conable and H.R. 4029 will preserve access to foreign capital, the latter would only allow privileged access. Accordingly, the Securities Industry Association prefers Gibbons-Conable since it broadens access by all United States issuers, corporate or governmental, to foreign capital. Thus, while we would prefer the targeted issue approach of H.R. 4029 to the continued necessity of utilizing Netherlands Antilles subsidiaries, we strongly believe that the Gibbons-Conable bill is the best means of preserving and broadening access by United States issuers to the Eurobond market.

2. Phaseout of the 30% Withholding Tax.—We see no tax policy justification for phasing in the elimination of the 30% withholding tax, as proposed in the Senate bill. A phased-in repeal is simply an attempt to subsidize temporarily the Netherlands Antilles and makes no sense in any tax reform legislation. Repeal should be immediate.

3. The effect of section 141 of H.R. 4170 on access to the Eurobond market.—The use of a Netherland Antilles finance subsidiary ordinarily results in an annual Netherlands Antilles income tax which, expressed as a percentage of the annual cost of Eurobond borrowing, ranges from .54% to more than 1%. Section 141 of H.R. 4170, as passed by the House of Representatives, will disallow a foreign tax credit for these foreign income taxes in the case where all of the subsidiary's assets are loans to the United States parent and other United States affiliates (which is generally the case when a United States corporation has tapped the Eurobond market). The effect of not allowing a credit is to raise the cost of the issue by the amount of the non-creditable tax—put differently, the result is no different than if the annual rate of interest were increased by 54 basis points or more, depending on the amount of Netherlands Antilles income tax. While some issuers may be able to avoid the impact of Section 141, we believe that this will rarely be the case and that the practical effect of Section 141 will be to preclude future access to the Eurobond market for most United States corporations.[3]

Becasue Section 141 would, in our judgment eliminate access to the Eurobond market for most United States corporations, we do not believe it should be enacted without an exception for finance companies so long as use of Netherlands Antilles finance companies continues to be the exclusive vehicle for access to the Eurobond market on a withholding tax free basis. If Congress adopts a phased-in repeal of the 30% withholding tax in order to protect the Netherlands Antilles, we believe that Section 141 should not apply to finance subsidiaries until the end of that period. Of course, if the Gibbons-Conable bill, or for tht matter H.R. 4029, were adopted, we would have no objection to Section 141. In fact, Section 141 would then discourage the continued use of Netherlands Antilles finance subsidiaries.

4. Conclusion.—The Securities Industry Association believes that continued and broadened access on the part of United States borrowers to overseas fixed income investors is of significant interest to this nation's financial health and that H.R. 3025 is the best means of achieving this objective. The Gibbons-Conable bill would both result in a net increase in United States tax revenues and facilitate capital flows into the United States.

A repeal of the 30% withholding tax on interest payments made to foreign investors should be immediate and not phased in over a period of years. Additionally, unless there is an immediate repeal of the 30% withholding tax, we strongly oppose the extension of Section 141 of H.R. 4170 to finance subsidiaries.

Thank you for the opportunity to testify.

SECURITIES INDUSTRY ASSOCIATION,
Washington, DC, April 30, 1984.

Re H.R. 3025.

Hon. DAN ROSTENKOWSKI,
Chairman, Ways and Means Committee, House of Representatives, Rayburn House Office Building, Washington, DC.

DEAR MR. CHAIRMAN: On behalf of the Securities Industry Association (SIA), as well as the other groups and associations listed below, we urge your support of H.R.

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[3] The effect of a 54 basis point increase in the cost of issuing obligations in the Eurobond market will be to eliminate all or substantially all of the savings resulting from borrowing in that market. This is indicated in the table attached as Appendix A which shows a representative sample of the savings achieved by United States issuers in the Eurobond market in the past 18 months. These savings have generally been well below 54 basis points and have averaged around 40 basis points. It is the cost saving which, in the overwhelming majority of cases, has been the main reason for choosing the Eurobond market over the domestic market.

3025, introduced by Reps. Gibbons and Conable. This bill would, by its elimination of the 30% tax on interest paid to foreigners, permit U.S. borrowers direct access to foreign capital. Presently, such access is possible only through the use of a Netherlands Antilles finance subsidiary.

Foreign lenders provide a critical source of capital for U.S. businesses. Because of the uncertainty surrounding pending treaty negotiations with the Antilles, we believe it is important that access to foreign capital be assured through tax legislation this year.

H.R. 3025 not only preserves access to this source of capital but makes it possible for all U.S. businesses as well as the U.S. government and its agencies to tap this market. Under the present regime, and under the approach suggested by Rep. Barnard, access would be limited to those U.S. corporations with sufficiently high credit rating and name recognition to borrow in a European-based market. While it is important that these present borrowers be afforded continued access, we believe that all U.S. borrowers (including the government) benefit from broadened access.

The 30% tax on foreign lenders is addressed in the Senate tax bill. The Senate bill would phase the tax down and out over a period of time, thereby attempting to encourage the use of Antilles subsidiaries for several additional years. Both the House and Senate tax bills would, however, curb the ability of the borrower to claim a foreign tax credit in respect of its income tax liability in the Antilles. In effect, the combination of these provisions threatens access to foreign capital for a period of years. Substitution of H.R. 3025 for the Senate phase-out would eliminate this threat.

Thank you for your attention and cooperation on this matter.

Sincerely,

SECURITIES INDUSTRY ASSOCIATION,
CHAMBER OF COMMERCE OF THE UNITED STATES,
EMERGENCY COMMITTEE ON AMERICAN TRADE,
NATIONAL ASSOCIATION OF MANUFACTURERS.

Mr. JENKINS. Thank you, Mr. Hyland, and I want to thank the panel for their testimony.

Let me ask a question or two. Since I am not real familiar with the Eurobond market and this is the first testimony I have heard, I am assuming that there is some self-interest involved, since we see people on either side here.

I will start with you, Mr. Hyland. You are for the total exemption, the total elimination of the 30-percent withholding. Would that, in effect, mean a great deal of business for the securities industry, for your association members?

Mr. HYLAND. The total elimination of the withholding tax, in our opinion, favors all issuers of U.S. source, and in that respect the Securities Industry Assocation serves those issuers, from the Treasury, through agencies, to corporations.

The Barnard bill serves, as presently drafted, to emphasize access on the part of U.S. corporations to the Eurobond market, and as such generally speaking the larger, more well-known U.S. corporations are the ones that have achieved that access.

We find, as the Securities Industry Association, that access as it has been through the Netherlands Antilles companies, and while it has favored the larger companies, is urgently necessary. But on a broader basis, we feel that the Treasury, the agencies, and the smaller corporations should not be precluded from similar access.

What I am concluding is that the SIA supports the Barnard position, but believes that nondiscriminatory access to the international markets is a preferable course.

Mr. JENKINS. Your industry would be better served financially with the other approach, rather than the Barnard approach, is that correct?

Mr. HYLAND. Yes. I think generally the strengthening of the U.S. capital market, which is——

Mr. JENKINS. I am not trying to pin you down. It is not surprising that witnesses come down on a position that helps them financially. I am not surprised by that particular posture.

Mr. CONABLE. Would the gentleman yield?

Mr. JENKINS. I would be happy to yield.

Mr. CONABLE. Would not the Barnard position give some particularly good status to American corporations, as opposed to the American Government?

Mr. HYLAND. The Barnard bill presently serves U.S. corporations better than the Gibbons-Conable will.

Mr. CONABLE. But you still believe that, as a matter of principle, it is better to have nondiscriminatory access to the market, to the Eurodollar market?

Mr. HYLAND. Yes.

Mr. CONABLE. You see, that puts a somewhat different light on it than simple self-interest here, because—I suppose you have some interest in Government access also?

Mr. HYLAND. We are certainly financially interested in that as well.

Mr. JENKINS. Mr. Hyland said he would be served better by the Conable-Gibbons approach than by the Barnard approach, I believe this is what he said.

Mr. HYLAND. Yes, I think the securities industry is probably better served with the Gibbons-Conable bill. It strengthens the position of the major firms and their ability to serve a wider range of clients.

Mr. JENKINS. I just wanted to see where everybody stood on this. Mr. Evans.

Mr. EVANS. I would differ from Mr. Hyland on that latter point slightly, because I think you have to look, not at a static situation, but the situation as it would develop over time. The Eurobond business is conducted by a relatively small group of major firms, three of which are sitting here.

We are one of them. I think of all the firms who will express themselves on this issue, including the others who have signed the SIA testimony, we come nearest to having a balance between our Eurobond business and our domestic bond business in terms of market share or however else you want to look at it.

I think over time the broader, the Gibbons-Conable version, would result in additional firms that are not in this select group today because they cannot afford to have full-fledged Eurobond issuing operations overseas, enable them to develop foreign clienteles and deal with them in the sale of bonds and the trading of bonds, as well as certain other banks on the Treasury side dealing in the Treasuries. So, I think that might be one of the more important effects over time.

Mr. JENKINS. Mr. Loverd, I assume you would be helped under either approach, is that right?

Mr. **Loverd**. We will make more money under the broad approach, if that is the direct question. Wall Street firms are driven from their trading desks. We make most of our money in the sales and trading of securities. Under the broad version, there would be a shift in origination from Europe to the United States, which would strengthen First Boston.

Under the broad version, the securities trading and sales business would pick up, which would increase our revenues. Therefore, we agonized before taking a position unfavor of the narrow version. Parenthetically, I would like to remind the committee that First Boston was a member of the SIA committee testifying a year ago at these hearings in support of the broad version.

But Representative Barnard's proposal as it was drafted raised some new questions and satisfied some new needs, which were the needs of issuers, such as the U.S. Treasury, agencies, FNMA, GNMA, or the corporate sector. We have spoken up because we believe that the narrow version is, in substance, an issuers' bill, while the broad version is a foreign investors' bill.

On another subject, I would like to clarify one matter. The broad version is not a bill for small American corporations. We live in the real world, and our experience—I believe we distribute as many U.S. securities overseas as any other firm—is very simple, very clear, very precise. We do not find overseas investors interested in any way whatsoever in purchasing the securities issued domestically or internationally of small, lower credit corporations. Overseas investors are extremely conservative. They wish primarily to preserve their capital. They are not in fact interest rate sensitive, and they do not invest in the securities of small companies.

Mr. **Jenkins**. Would you like to comment, Mr. Mendoza?

Mr. **Mendoza**. Mr. Chairman, I would like to say that our narrow self-interest is served best by the narrow compromise approach which we have advocated; second best by Gibbons-Conable; and worst of all by the current situation, where the phased-in repeal and the re-sourcing problem would effectively eliminate access.

Mr. **Jenkins**. Mr. McIntyre, you only represent the people.

Mr. **McIntyre**. Yes; I want to offer you a rather different outlook from the "public-spirited" views you have just heard.

You know, the current situation is that it seems like we are short of everything in this country. Our exports are $110 billion short of our imports, at least 10 million Americans can't find work, and our national savings rate is 2 or 3 percent of the GNP lower than it normally has been. And perhaps underlying all of that is the fact that the Federal Government is a couple of hundred billion dollars in the hole and unless major policy changes are made, is going to stay there every year for the foreseeable future.

And what we are talking about here today is really nibbling on the edges of any of these problems, because the real problem is the federal deficit. But if we are going to do some nibbling, it seems to me we ought to focus on what we think the worst problem is.

If we expand access to foreign capital markets for U.S. firms, then that is going to have some helpful short-run impact on our overall investment situation; there is no question about that. On the other hand, it is going to have a harmful effect, an added harmful effect, on our exports. If instead we take the route I have suggested and we reduce the artificial incentives for our companies to borrow in foreign capital markets, it is going to help our exports; it also is going to hurt our domestic investment situation somewhat in the short run—although getting people back to work in export- and import-sensitive industries would probably help our investment situation substantially in the longer run.

Those things are all true, and you have got to make a choice. Where is our biggest problem? It seems to me if we are worried about American jobs, which is what my constituency worries about the most, that the export issue is the more significant one, and that is what we ought to be focusing on and that is why we should be limiting, rather than expanding, the access.

Mr. JENKINS. Thank you, Mr. McIntyre.

Mr. Conable.

Mr. CONABLE. No questions.

Mr. JENKINS. Did you have any further comment, Mr. Evans?

Mr. EVANS. Thank you. I just wanted to observe that we are now in a situation where the strong dollar is a problem. We have all been reading recently more and more of the consequences we would face if, as will inevitably happen, the dollar declines, starts to decline precipitously: The effect on the increase in our inflation rate, the immediate effect; the measures the Federal Reserve would have to take to step the outflow in terms of interest rates.

And I would suggest that, whereas this bill would not have an immediate significant effect on the exchange rate of the dollar, we would all be more comfortable today if a higher proportion of foreign investment in this country was in more stable bonds, rather than unstable short-term instruments.

Mr. JENKINS. Thank you very much, and I thank the panel for your testimony.

The next panel: Mr. Robert Butcher, vice president, Capital Markets Group of Citicorp; Stuart McFarland, executive vice president and chief financial officer of Federal National Mortgage Association; John Donaldson, Jr., treasurer of Avon Products, Inc.; Mr. Richard Bushey, vice president and controller of Southern California Edison Co.; and, representing the chamber of commerce, Mr. Glenn White, member of the taxation committee and director of Dow Chemical Tax Department, with Mr. Bernstein, director of International Tax Policy.

We will commence the testimony of this panel with Mr. Robert Butcher of Citicorp. Mr. Butcher.

STATEMENT OF ROBERT M. BUTCHER, VICE PRESIDENT, CAPITAL MARKETS GROUP, CITICORP, ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. BUTCHER. Thank you, Mr. Chairman and members of the committee.

My name is Robert Butcher and I am pleased to appear here today on behalf of the Emergency Committee for American Trade [ECAT] to provide information to the extent that I can on the Eurobond markets and ECAT's position advocating full elimination of the 30 percent withholding tax as proposed in H.R. 3025.

ECAT is an organization of the heads of 63 U.S. business firms with substantial business operations overseas. Worldwide sales of these firms total about $700 billion annually. They employ over 5 million workers.

ECAT has long advocated, and continues to advocate, the elimination of the 30-percent withholding tax on all interest paid to foreign investors, whether on overseas or domestic notes or bonds, whether on corporate or on U.S. Treasury or other Federal agency issues.

I am a vice president of Citicorp specializing in borrowing money. My primary focus is intermediate and long-term funding, meaning funding having a maturity of 1 or more years. In that capacity, I have negotiated borrowings in six foreign currencies, as well as large numbers of domestic and Eurodollar transactions. The dollar denominated Eurobond issues were borrowed in the Netherlands Antilles through a wholly owned financing subsidiary of Citicorp called Citicorp Overseas Finance Corp., which I will refer to, if I may, as COFC.

Citicorp, through COFC, has already borrowed funds in excess of $2 billion. These funds are lent to domestic subsidiaries across the United States, primarily engaged in consumer finance, that is, first and second mortgages on housing and mobile homes, automobile loans, and other types of consumer loans.

Continuous access to the Eurobond market for funding is required, because Citicorp is already a large borrower in the domestic market. In 1983 it accounted for 8.5 percent of the domestic bond markets. Indeed, Citicorp cannot continue its current and anticipated levels of consumer lending without access to the Eurobond market.

To facilitate the use of the Eurobond markets, Citicorp recommends the elimination of the U.S. withholding tax. I have given in my testimony several reasons, but I would like to say that most importantly the demise of the withholding tax will hasten the integration of the domestic and Eurobond markets. More foreign investors will be able to buy and sell bonds issued both in the United States and abroad and there will be increasingly homogeneous terms offered in the United States and in Europe on debt securities.

I think the elimination will foster the development of a number of mechanical and legal devices, such as bearer-registered options, which will facilitate the flow of funds between markets, subject of course to compliance with necessary and proper legal and tax requirements.

The integration of the U.S. and Eurodollar bond markets will bring greater liquidity—and I would like to emphasize the word "liquidity" because I think that is the whole question at hand with the corporate and the Federal Government access to markets. It will foster a greater volume of funds flowing into the markets, hopefully lower borrowing costs to borrowers, and allow corporate borrowers other than just the largest, such as ourselves, to access the market to overseas investors.

The elimination of the withholding tax on all U.S. Treasury securities across the board could enable the Treasury to raise funds as inexpensively as possible. However, some questions have been raised here in Washington about the advisability of eliminating the withholding tax on interest paid on U.S. Treasury and other agency securities, excluding short-term discount instruments.

In the U.S. market, where corporations and the Treasury compete on essentially the same terms relative to taxes, corporations usually pay higher interest rates than does the Treasury. But there are still sufficient sources to provide funds for both types of borrower. This would be the same case overseas, we think. The market balances out investor interest between corporate and Government securities over time.

The concern voiced by some commentators that inflows of new foreign money into the Government securities markets will be large and will exacerbate problems caused by a strong dollar seems overstated. For one thing, a number of significant overseas investors are not concerned about the withholding tax, and for another, the greatest overseas buying power for Treasury securities, for example, lies in foreign governments and central banks, which are exempt from withholding tax. Another point is that in the past decade such as in the 1976–78 period, there has been no direct correlation between changes in the exchange rates of the U.S. dollar versus other major currencies and shifts of capital investment in the United States into foreign hands.

We do not believe that the withholding tax on interest paid on U.S. Treasury or other Federal securities should be eliminated on only new or targeted issues of such securities, and I have given some reasons inside my testimony, which I believe you have copies of.

The gist of the argument is that I think that it would impair the very liquidity which makes the domestic market for Government securities so successful and provides such a firm underpinning for a vigorous corporate bond market.

I would be pleased to answer any questions you have.

[The prepared statement follows:]

STATEMENT OF ROBERT M. BUTCHER, VICE PRESIDENT, CAPITAL MARKETS GROUP, CITICORP, ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. Chairman and members of the Committee, my name is Robert M. Butcher. I am pleased to appear here today on behalf of the Emergency Committee for American Trade (ECAT) to provide information to the Committee, to the extent that I can, on the Eurobond markets and on ECAT's position advocating full elimination of the 30% U.S. "withholding" tax as proposed in H.R. 3025 on interest received by foreigners on portfolio debt investments.

ECAT is an organization of the heads of 63 U.S. business firms with substantial overseas business operations. Worldwide sales of these firms total about $700 billion annually. They employ over five million workers. ECAT has long advocated, and continues to advocate, the elimination of the 30% withholding tax on all interest paid to foreign investors, whether on overseas or domestic notes or bond issues and whether on corporate or on U.S. Treasury or other federal agency issues.

I am Vice President of Citicorp specializing in liability management. My primary focus is intermediate and long term funding (i.e., funding having a maturity of one or more years) for the corporation worldwide in all currencies. In that capacity, I have negotiated borrowings in six foreign currencies as well as large numbers of domestic and Eurodollar transactions. The dollar denominated Eurobond issues were borrowed in the Netherlands Antilles through a wholly owned financing subsidiary, Citicorp Overseas Finance Corporation N.V., which is referred to as COFC.

As in the case of a number of other corporations, Citicorp's overwhelming focus outside the U.S. bond market is on the Eurobond market. No large borrower of funds in the world today can ignore the Eurodollar bond market. It is a sizable source of funds, and it is growing more rapidly than the U.S. corporate bond market. From a size of approximately $22 billion in 1981, the Eurobond dollar market grew to approximately $35 billion in 1983. By way of contrast, the domestic corporate bond market was approximately $34 billion in 1981 and $39 billion in 1983.

Citicorp, through COFC, has already borrowed funds in excess of $2 billion from the Eurobond markets. These funds are lent to domestic subsidiaries primarily engaged in consumer finance—i.e. first and second mortgage loans on housing and loans for consumer purchases such as mobile homes and automobiles. Continuous access to the Eurobond market for funding is required because Citicorp is already a large borrower in the domestic bond markets. In 1983 Citicorp accounted for 8.5% of the domestic bond markets. Indeed, Citicorp cannot continue its current and anticipated levels of consumer lending without access to the Eurobond market.

To facilitate the use of the Eurobond markets, Citicorp strongly recommends the elimination of the U.S. withholding tax as proposed in H.R. 3025 for several reasons. Elimination will enable us to issue debt directly into the Eurobond market without having to worry about the status of the tax treaty with the Netherlands Antilles. It will save the expenses incurred by having separate operations in the Netherlands Antilles. Most importantly, the demise of the withholding tax will hasten the integration of domestic and Eurobond markets. More foreign investors will be able to buy and sell bonds issued both in the U.S. and abroad. There will be increasingly homogenous terms offered in the U.S. and in Europe on debt securities.

Elimination will also foster the development of a number of mechanical/legal devices, such as the bearer/registered option, that will facilitate the flow of funds between markets, subject, of course, to compliance with tax and legal requirements. The integration of the U.S. and Eurodollar bond markets will bring greater liquidity to investors, direct a greater volume of funds to these markets overseas, perhaps lower costs to borrowers, and allow corporate borrowers other than the very largest access to overseas investors.

The elimination of the withholding tax on U.S. Treasury securities could allow the Treasury to raise funds more inexpensively. However, some questions have been raised about the advisability of eliminating the withholding tax on interest paid on U.S. Treasury and agency securities (excluding short term discount instruments). For example, would the elimination divert foreign investment into Treasury securities, thus depriving private corporations of opportunities to borrow in foreign markets? If yields on Government notes are bid down, because of increased foreign investor interest, yields on corporates will become relatively more attractive, especially overseas insofar as the withholding tax barrier to a broader, more liquid corporate securities market is eliminated. This improvement in the attractiveness to foreigners of corporate debt relative to Government debt should balance out over time, just as it has in the domestic U.S. markets. In the U.S. market, where corporations and the Treasury compete on essentially the same terms relative to taxes, corporations usually pay a higher interest rate than the Treasury, but there are sufficent sources to provide funds for both types of borrower. This would also be the case overseas.

The concern voiced by some commentators that inflows of new foreign money into the Government securities markets will be large, and will exacerbate problems caused by a strong dollar, seems overstated. For one thing, a number of significant overseas investors are not concerned about the withholding tax. For example, the greatest overseas buying power for Treasury securities lies in foreign governments and central banks, which are exempt from withholding taxes. For another thing, in the past decade there has been no direct correlation between changes in the exchange rates of the U.S. dollar versus other major currencies and shifts of capital investment in the U.S. into foreign hands.

We do not believe that the withholding tax on interest paid on U.S. Treasury or other federal securities should be eliminated only on new issues of such securities. That change would lead to significant market confusion as to which issues were exempt and which were not (we speak by experience because this situation exists in the U.K. and is the source of problems for foreign investors). That change could also lead to different prices, resulting from different tax treatment to non-resident holders. It could impair the very liquidity which makes the domestic market for Government securities so successful and provides such a firm underpinning for a vigorous corporate bond market.

The provision on 30% withholding adopted by the Senate as an amendment to H.R. 2163 would phase out the tax over a five-year period. The timing of the repeal of the 30% tax has been made crucial because of a separate provision in both versions of the tax bill to change the source of income rules for purposes of the foreign tax credit limitation in Section 904. This provision (which is contained in Section 141 of H.R. 4170 and Section 128 of the Senate package) would in effect deny the foreign tax credit to U.S. parent companies for taxes paid by their Netherlands Antilles finance subsidiaries. This change in current law would significantly alter the economic feasibility of Eurobond financings through the Netherlands Antilles. Therefore, we would recommend either that the 30% withholding tax be repealed effective with enactment of this bill or, as a less desirable alternative, the application of the resourcing provision to Eurobond issues should be held in abeyance until the withholding tax is completely phased out. In any event, the provisions should be reconciled to prevent having the two changes operate at cross-purposes.

In summary, we strongly recommend a clean and simple elimination of the U.S. 30% withholding tax on interest earnings as proposed in H.R. 3025.

Mr. JENKINS. Thank you, Mr. Butcher.

Mr. McFarland.

STATEMENT OF STUART A. McFARLAND, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. McFARLAND. Mr. Chairman and members of the committee, my name is Stuart McFarland. I am the executive vice president and chief financial officer of the Federal National Mortgage Association, more commonly known as Fannie Mae. Our only business is providing a secondary market for residential mortgages.

I am here today to express our enthusiastic support for the repeal of the 30-percent withholding tax on interest paid to foreign investors in corporate bonds. Both proposals before the committee today would allow direct access by U.S. borrowers to the international money markets.

I would especially like to commend Congressmen Gibbons and Conable for their foresight in introducing H.R. 3025 and their perseverance on this issue. I know that providing direct access to overseas markets has been a priority for both of them for the last several years. We hope the Congress will pass this long overdue legislation this year.

Congress rechartered Fannie Mae in 1968 as a privately managed, stockholder-owned corporation, paying taxes at the full corporate rate. We receive no appropriated funds. Fannie Mae has over 33,000 shareholders with over $1.2 billion of equity at risk, with 66 million shares of common stock outstanding. Our stock is listed and actively traded on the New York Stock and other exchanges.

Fannie Mae, as a portfolio mortgage investor, is a financial intermediary for housing finance. We borrow funds only in the short- and intermediate-term domestic financial markets and purchase longer maturity mortgages from lenders throughout America. Fannie Mae borrows in the domestic bond market to finance its purchase of new mortgages and to refinance existing debt that supports the mortgages it already owns. As of March 31, 1984, we owned over $78 billion in mortgages, approximately 1 of every 14 in America. The money we raise goes to serve the low- and moderate-income housing market to which we are committed by our congressional charter. For example, the average size loan we purchased in 1983 was just over $60,000.

Current laws place U.S. issuers of investment securities who do not use foreign financing subsidiaries at a serious competitive disadvantage in the overseas capital market. The proposals before the committee today would eliminate these barriers and make it unnecessary for U.S. borrowers to use offshore subsidiaries to gain access to international money markets.

We believe it is important to remove the 30-percent withholding tax to assure a steady flow of foreign capital into the United States. This could be an insurance policy against higher domestic interest rates. If access to foreign capital is curtailed, domestic users of credit would have to raise funds in the U.S. capital markets only, which could pressure interest rates to rise.

Fannie Mae has asked the Department of the Treasury for authority to borrow overseas through a Netherlands Antilles subsidiary. The Treasury does not object to Fannie Mae borrowing overseas but will not permit use of a Netherlands Antilles subsidiary at this time. They believe this would disrupt ongoing treaty negotiations with the Netherlands Antilles.

Housing needs access to overseas funds for several reasons. First, existing domestic sources of funds will be inadequate to supply the projected need of $1.3 trillion in affordable mortgage funds over the balance of the 1980's. Second, we estimate conservatively that if Fannie Mae had had access to the Eurobond market during 1982 and 1983, the corporation could have saved as much as $12½ million in borrowing costs. This modest participation in the overseas capital market, approximately $1 billion in each borrowing year, could have substantially assisted Fannie Mae in its support of housing finance during the recent trying economic times and could have resulted in lower mortgage rates for home buyers.

Suppose, for example, a typical home buyer could have saved 50 basis points, one-half of 1 percent, on a mortgage because Fannie Mae had lower borrowing costs. On a 30-year fixed-rate mortgage of $75,000, that would mean a lower monthly payment of $30, or $3,600 over a 10-year period. This difference could determine the ability for some Americans to purchase a home in today's high interest rate environment.

Fannie Mae can channel overseas funds into housing because we are recognized as a large issuer of quality debt, similar to Citibank, General Electric, Sears, and other companies now borrowing in Europe. As in the United States, Fannie Mae has the capacity and the market reputation needed to serve as a bridge between foreign capital markets and the domestic mortgage market.

Passage of H.R. 3025 or H.R. 4029 would put housing on an equal footing abroad with other borrowers and would help to assure the future availability of adequate mortgage funds. Housing would benefit by Fannie Mae's ability to borrow overseas.

Elimination of the 30-percent withholding tax is supported by those associated with housing, the Mortgage Bankers Association of America, the American Bankers Association, National Council of Savings Institutions, National Association of Realtors, and the National Association of Homebuilders.

Mr. Chairman, I appreciate the opportunity to testify today. I strongly urge the committee to favorably consider this legislation. It is essential to provide access by housing to the international money markets. If Fannie Mae were to borrow overseas, it would benefit prospective American home buyers by providing an additional source of affordable mortgage money.

Thank you very much.
[The prepared statement follows:]

STATEMENT OF STUART A. MCFARLAND, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. Chairman and Members of the Committee; my name is Stuart McFarland. I am Executive Vice President and Chief Financial Officer of the Federal National Mortgage Association, more commonly known as Fannie Mae. Our only business is providing a secondary market for home mortgages.

I am here today to express our enthusiastic support for the repeal of the thirty percent withholding tax on interest paid to foreign investors in corporate bonds. The proposals before the Committee today would allow direct access by U.S. borrowers to the international money markets.

I would especially like to commend Congressmen Gibbons and Conable, two senior members of this Committee, for their foresight in introducing H.R. 3025 and their perseverance on this issue. I know that providing direct access to overseas markets has been a priority for both of them for the last several years. We hope the Congress will enact this long overdue legislation this year.

Originally formed as a federal agency in 1948, Congress chartered Fannie Mae in 1968 as a privately managed, stockholder-owned corporation, paying taxes at the full corporate rate. We receive no appropriated funds. Fannie Mae has over 33,000 shareholders, with 66 million shares of common stock outstanding. Our stock is listed and actively traded on the New York and other stock exchanges.

Fannie Mae, as a portfolio mortgage investor, is a financial intermediary for housing finance. We borrow funds in the short and intermediate-term financial markets to purchase longer maturity mortgages from lenders throughout America. As of March 31, 1984, we owned over $78 billion in mortgages, approximately one of every fourteen in America. Fannie Mae is the largest investor in mortgages in the United States. Fannie Mae also operates a conventional mortgage-backed securities program. Since its beginning in late 1981, we have issued domestically almost $32 billion of these securities.

Dealing with approximately 4,000 approved lenders, Fannie Mae transforms mortgages from small, illiquid and local investments into highly marketable, blue-chip securities that attract money that is otherwise largely unavailable to housing. The money we raise goes to serve the low-moderate and middle-income housing market to which we are committed by our congressional charter. The average size loan we purchased in 1983 was just over $60,000.

Fannie Mae's Charter requires it to serve housing at all times, good and bad, not just when housing happens to provide the most rewarding investment opportunities. R. Thomas Powers, chief economist for Goodkin Research Corp., was recently quoted in Business Week, magazine as saying that Fannie Mae's purchase of mortgages in 1982 and 1983, when there were few, if any, other investers, "is one of the basic reasons that we've had a turnaround in the housing industry.

To sustain its secondary mortgage market activities, Fannie Mae issues its own debentures in the domestic bond market. Fannie Mae borrows in the domestic capital market to finance its purchases of mortgages and to refinance existing debt to support the mortgages it already owns.

The role of the secondary mortgage market, in which Fannie Mae is the central player, has become increasingly important in recent years. We conservatively project that in the years ahead over half of home finance credit will come from secondary market sources. But U.S. purchasers of mortgage-backed securities will provide only a part of the projected $1.3 trillion in needed mortgage funds for the balance of the decade. The brunt of the housing finance burden will still be borne by Fannie Mae and other portfolio investors who draw funds from depositors or the bond market. Intermediate and long-term funds from the overseas markets can provide additional, supplemental support for mortgage finance and homeownership.

Removal of the 30 percent withholding tax

Current tax laws place U.S. issuers of investment securities who do not use financing subsidiaries at a serious competitive disadvantage in the overseas capital market. The proposals before the Committee today would eliminate these barriers and make it unnecessary for U.S. borrowers to use cumbersome offshore subsidiaries to gain access to the international money markets.

Fannie Mae has asked the Department of the Treasury for authority to borrow overseas through a Netherlands Antilles (N.V.) subsidiary. The Treasury does not object to Fannie Mae borrowing overseas, but not through an N.V. subsidiary. They believe this would disrupt ongoing treaty negotiations. As a result, Fannie Mae has not been able to borrow overseas even though all other privately owned companies, including federal savings and loans and banks, can do so if they wish. This deprives potential American homebuyers of an opportunity to obtain mortgages at lower interest rates.

Foreign and U.S. corporations and foreign governments borrow at lower interest rates in the Eurobond market. The lower effective bond yields required by investors in the international markets largely explain the growth in annual new issues of Eurodollar bonds from $7.3 billion in 1978 to $38.4 billion in 1983. The 1983 figure exceeded domestic corporate bond issuances in that year.

We believe it is important to remove the 30 percent withholding tax to assure a steady flow of foreign capital into the United States. This could be an insurance policy against higher domestic interest rates. If access to foreign capital is curtailed, domestic users of credit would have to raise funds in the U.S. capital markets only, which could pressure interest rates to rise.

Why housing needs access to overseas funds

Housing needs access to overseas funds for two reasons. First, existing domestic sources of funds will be inadequate to supply the projected need for $1.3 trillion in affordable mortgage funds over the balance of the 1980's. And, U.S. purchasers of mortgage-backed securities and bonds can pick up only a part of the shortfall. Housing activity is important to the domestic economy. As shown in Appendix I, housing construction has significant employment effects.

Second, we estimate conservatively that if Fannie Mae had access to the Eurobond market during 1982 and 1983, the corporation would have saved at least $12.5 million in borrowing costs. This modest participation in the overseas capital market—approximately $1 billion in borrowing each year—could have substantially assisted Fannie Mae in its support of housing finance during the recent trying economic times and could have resulted in lower mortgage interest rates for homebuyers.

Year and estimated issue of FNMA Eurobonds	All-in cost saving per transaction	Estimated dollar savings (millions)
1982—$700 million-$1 billion	50–75 bp	$3.5–$7.5
1983—$1 billion	40–50 bp	$4.0–$5.0

Suppose a typical homebuyer could have saved 50 basis points, i.e., one-half of one percent, on a mortgage because Fannie Mae had lower borrowing costs. On a 30-year fixed-rate mortgage of $75,000, that would mean a lower monthly payment of $30 or $3,600 over a ten year period. This difference could determine the ability for some to purchase a home and not in today's high interest rate environment.

Fannie Mae can channel overseas funds into housing. Foreign investors are not familiar with the complexities of direct investment in individual mortgages. But, they know Fannie Mae is a large issuer of quality debt. Our name recognition is the same as that of Xerox, General Electric, Coca-Cola and other companies now borrowing in Europe. As in the United States, Fannie Mae has the capacity and the market recognition needed to serve as the bridge between foreign capital markets and the domestic mortgage market.

Finally, most foreign investors want to lend funds for five to ten year terms, while U.S. investors generally lend for shorter terms. Fannie Mae wants to borrow funds with those maturities to help correct its mismatched balance sheet. Most of our mortgage assets have an average life of ten years or more, while the debt that finances them rolls over every three years. By borrowing overseas at longer maturities, Fannie Mae could extend its debt at lower cost, thereby strengthening the financial integrity of its balance sheet. This would enable us to continue to provide countercyclical support for housing when other private sources of mortgage credit disappear.

Enactment of H.R. 3025 or H.R. 4029 would put Fannie Mae and housing on an equal footing abroad with other borrowers and would help to assure the future availability of adequate mortgage funds. Housing would benefit by Fannie Mae's ability to borrow overseas.

CONCLUSION

Fannie Mae has both capacity and market recognition necessary to bridge the overseas money markets and U.S. housing needs. During the recent high interest rate cycle, Fannie Mae borrowed heavily in the domestic bond market to meet the demand for mortgage funds. Unfortunately, Fannie Mae's exclusion from the overseas capital markets measurably affects our cost of funds and, in turn, ultimately influences the mortgage rate homebuyers must pay. Providing direct access to overseas markets would also put Fannie Mae on an equal footing with other privately owned and managed companies.

Mr. Chairman, I strongly urge the Committee to favorably consider this legislation. It is essential to provide access for housing to the international money markets. Allowing Fannie Mae to borrow overseas will benefit prospective American homebuyers by helping to ease mortgage interest rates.

ECONOMIC IMPACT OF RESIDENTIAL CONSTRUCTION

The construction of 1,000 single family units generates an estimated 1,759 man years of employment and more than $32,500,000 in wages. The total economic impact of these units (employing a multiplier of 2) is $146,900,000, while the total tax impact is $14,700,000.

The corresponding figures for 1,000 multifamily units are 826 man years of employment, $15,200,000 in wages, $67,200,000 in total economic impact, and $7,200,000 in total tax impact.

	Employment impact of 1,000 new single family units		Employment impact of 1,000 new multifamily units	
	Man years	Wages	Man years	Wages
All industries	1,759	$32,540,000	826	$15,170,000
Construction	627	13,600,000	318	6,900,000
On site	525	11,440,000	273	5,950,000
Off site	102	2,160,000	45	950,000
Other industries	897	13,960,000	443	6,890,000
Manufacturing	397	6,430,000	240	3,890,000
Wholesale trade, transportation and services	355	4,610,000	153	1,990,000
Mining and all others	145	2,920,000	50	1,010,000
Land development	235	4,980,000	65	1,380,000

	Tax impact of 1,000 new single family units	Tax impact of 1,000 new multifamily units
Total tax impact, all levels	$14,718,000	$7,188,000
Total Federal taxes	12,658,000	6,028,000
Federal personal income tax	4,090,000	1,890,000
Federal corporate income tax	4,240,000	2,120,000
Builders	3,230,000	1,540,000
Supplies	1,010,000	580,000
Social security tax	4,328,000	2,018,000
State personal income tax	550,000	260,000
Local real estate tax	1,510,000	900,000

	Total economic impact of 1,000 new single family units	Total economic impact of 1,000 new multifamily units
Value per unit	$83,000	$40,000
Total economic impact	146,910,000	67,200,000

Source: NAHB Economics Division.

Mr. Jenkins. Mr. White.

Let me say this to the panel. All of the written statements will be made a part of the record. If you would like to briefly summarize, since we have a series of votes coming up on the House floor, we will be delighted to hear from you.

Mr. White.

STATEMENT OF GLENN W. WHITE, DIRECTOR, TAX DEPARTMENT, DOW CHEMICAL CO., AND MEMBER, TAXATION COMMITTEE, CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY RACHELLE B. BERNSTEIN, DIRECTOR, INTERNATIONAL TAX POLICY, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. White. Thank you, Mr. Chairman.

I am Glenn W. White, director of the tax department of the Dow Chemical Co. and a member of the Taxation Committee of the Chamber of Commerce of the United States. I am accompanied today by Rachelle B. Bernstein, director of international tax policy for the chamber.

We welcome the opportunity to voice our strong support for H.R. 3025. We represent 200,000 small and large businesses in the United States who are the chamber's members. The Dow Chemical Co. has more than $400 million in foreign borrowings that have been made through an offshore finance company. We would have a distinct preference for direct access to the foreign bond markets through our parent company. If H.R. 4170 is adopted with the resourcing rule of section 141 remaining in the bill, then we would have to weigh coming to the U.S. market for the sum of our foreign borrowings. If H.R. 3025 is adopted, we will probably directly assume the foreign debt that we already have outstanding.

Elimination of the withholding tax paid to foreign portfolio investors will help reduce the capital shortage that now exists in the United States.

U.S. business cannot borrow directly from foreign lenders under existing law unless they can absorb the withholding tax. Therefore, the foreign lender—excuse me, the foreign lender can place his funds with other borrowers without this burden and so will not accept the added cost of the U.S. withholding tax. As a result, U.S. businesses are forced to use offshore finance companies to compete for funds from foreign lenders.

The Netherlands Antilles has testified today in support of this practice. The Internal Revenue Service and Treasury Department have both resisted this practice. Business is left in the middle.

American business needs capital. The high interest rates which have prevailed in recent years have restricted capital availability. Adoption of H.R. 3025 will provide American business freer access to international money markets. Removal of the withholding tax on interest will help borrowers who do not use foreign markets. Small borrowers compete with Treasury and large firms for domestic capital at this time to the extent that either class of large lenders goes offshore, the pressure on domestic markets will be alleviated.

Mr. Barnard's calculations of the added costs to Treasury do not take into account this fact. Continued use of offshore finance vehicles is already a serious problem. It is not clear that a favorable treaty status will continue. The IRS is already litigating the use of offshore finance companies. If section 141 of H.R. 4170 is adopted, it will become very unattractive to continue the maintenance of debt through foreign finance subsidiaries.

With this unfavorable climate, access to Eurodollar funds is becoming doubtful. Loss of access to this market could foreclose the use of over $35 billion in foreign borrowings and drop that burden on the U.S. money markets.

The proposal to phase out the withholding we believe is unrealistic. The recharacterization rules proposed under section 141 will begin capital flight from the Netherlands Antilles. Please do not place the use of offshore companies under a penalty while de facto prohibiting the use of direct borrowing. Access to Euromoney markets is vital for U.S. business.

It does not make sense to preclude the U.S. Government from the general use of the foreign market. The potential savings to all U.S. citizens is substantial. For that reason, H.R. 3025 is superior to the alternative proposals. The chamber of commerce commends the chairman for holding hearings on this important issue and urges that H.R. 3025 be included in the conference report of H.R. 4170.

Thank you very much for letting us present our views.

[The prepared statement follows:]

STATEMENT OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, GLENN W. WHITE, MEMBER, TAXATION COMMITTEE

I am Glenn W. White, Director of the Tax Department of the Dow Chemical Company and a member of the Taxation Committee of the Chamber of Commerce of the United States. I am accompanied today by Rachelle B. Bernstein, Director of International Tax Policy for the Chamber. We welcome the opportunity to testify in support of H.R. 3025

SUMMARY

The Chamber strongly supports elimination of the withholding tax on interest paid to foreign portfolio investors. The United States faces a critical shortage of capital. Decreasing levels of investment in American industry have contributed substantially to the decline in our productivity. The elimination of the 30 percent tax on interest paid to foreign portfolio investors could help to ease this situation by providing direct access to foreign lenders for foreign persons, including the U.S. government.

PRESENT LAW

The taxes imposed on interest paid to foreign investors vary with the nature of the interest and the circumstances of the foreign recipient. If interest is paid to a foreign investor as a result of ongoing business activities in the United States, it is included with the other income and expenses of the business and taxed at the standard corporate or individual rates.

Interest received by a foreign investor from passive investment in the U.S. generally is subject to tax at a flat rate of 30 percent on the gross amount paid. This is usually reduced for lenders in countries with which the U.S. government has a tax treaty. The tax is collected by the person paying the interest, through withholding 30 percent from the full amount to be paid.

In order for U.S. borrowers to compete for foreign investment capital, they must either issue obligations the interest on which is not subject to tax in the U.S. or pay higher interest rates. This is because these obligations compete primarily with debt securities sold in the Eurobond market which are free of taxes withheld by the country of issuance. As a practical matter, raising interest rates to compensate for the 30 percent tax imposed by the U.S. would make the cost of foreign capital too expensive. However, U.S. corporations can presently borrow through the Eurobond market by establishing financing subsidiaries in countries which have a tax treaty with the United States providing for an exemption from U.S. tax for U.S. source interest paid to foreign persons. Almost all of these financing subsidiaries are located in the Netherlands Antilles. (The U.S Treasury Department has been in the process of renegotiating the U.S./Netherlands Antilles Tax treaty for more than three years.)

NEED FOR ADDITIONAL CAPITAL

American business faces a severe capital shortage. The heavy demands for capital and the limited supply of funds available have caused interest rates to rise to unprecedented levels in recent years and remain at rates which severely restrict the ability of businesses to borrow funds needed for corporate expansion. Removing the withholding tax on interest paid to foreign portfolio investors will allow American business freer access to international markets, and thus increase the amount of funds available for borrowing.

The inherent strength and stability of this nation is one of the prime reasons that foreigners wish to invest in the United States. The growth in the economic strength of the European Community and Japan, however, has made investment in their industries increasingly attractive.

Many countries have helped their industries to increase their share of international investment by eliminating taxes on interest paid to international investors in some way.

American industry will be placed at a competitive disadvantage if foreign issuers may borrow on the Eurodollar market without withholding tax and U.S. companies cannot. Funds would be attracted for foreign companies that might otherwise have gone to purchase American debt securities.

The removal of the tax on interest paid to foreign investors also will help to ease credit problems for U.S. home buyers, farmers, and small businesses. While these small borrowers generally will not be able to attract foreign investment funds, they presently compete with major corporations and the U.S. government for the dollars available for domestic investment. By allowing U.S. businesses and the U.S. government to sell their debt instruments in foreign markets more easily, pressure in the domestic markets will be reduced. This in turn will allow more money to be made available to smaller borrowers.

H.R. 4029, introduced by Congressman Barnard, is also being considered by the Committee today. H.R. 4029 would provide direct access to the Eurobond market for corporate bond issuers only, whereas H.R. 3025 provides unimpeded access to foreign capital for all borrowers. Although H.R. 4029 would help U.S. corporations wishing to borrow on the Eurobond market and would relieve the demand for domestic capital to the degree these companies are able to borrow elsewhere, we believe that it is preferable to provide access to foreign capital to the greatest possible number of U.S. borrowers. Under H.R. 3025, the U.S. government, the Federal National Mortgage Association (FNMA), and others, as well as U.S. corporations, would have access to foreign capital. We believe that this broadened access will have a far greater effect on lowering U.S. interest rates.

REPEAL OF WITHHOLDING TAX PROVIDES BEST ACCESS TO INTERNATIONAL CAPITAL MARKETS

Although U.S. borowers can presently gain access to international capital markets through the use of financing subsidiaries in countries like the Netherlands Antilles, such devices do not provide efficient access to international capital markets. Generally, debt securities which are issued in the Eurobond market are free of taxes withheld at the source and put the risk of any such tax on the issuer. Issuers usually have a right to call the obligations in the event that a withholding tax is imposed as a result of a change in law or interpretation occurring after the obligations are issued. Presently, a number of prospective U.S. borrowers are reluctant to utilize financing subsidiaries in the Netherlands Antilles because the uncertainty arising from the present treaty negotiations has caused a fear that changes in or termination of that treaty may result in the prepayment of overseas issuances.

Section 141 of H.R. 4170 would restrict the ability of U.S. borrowers to use Netherlands Antilles financing subsidiaries by resourcing the income subject to Netherlands Antilles tax which would result in the denial of the foreign tax credit for taxes paid there. The additional tax burden which would result from the double taxation of this income will obviously add to the cost of borrowing in the Eurobond market and, we believe, in many cases, will make it too expensive for companies to borrow in this market.

Repeal of the withholding tax would allow access to the Eurobond market by U.S. businesses which have heretofore avoided this source of capital because of the complicated procedures involved in establishing a Netherlands Antilles subsidiary. Finally, investments made in the U.S. may be more attractive to foreign lenders because commissions on securities transactions are generally lower in the United States.

PHASE-OUT OF WITHHOLDING TAX

The Senate Finance Committee bill provides for a four year phase-out of the 30 percent withholding tax. That Committee's concern was that an immediate repeal of the withholding tax, without a transitional period, would have a negative impact on the economy of the Netherlands Antilles. The Chamber does not believe this consideration is appropriate as a matter of tax policy. Furthermore, we believe that a great deal of the borrowing which presently goes through the Netherlands Antilles would be terminated as a result of the recharacterization of income rules included in Section 141 of H.R. 4170 and Section 128 of the Senate Finance Committee bill. Therefore, the Netherlands Antilles government would not be helped very much by the failure to repeal this tax for four years, and U.S. borrowers would be badly hurt as a result of impeding access to the Eurobond market for the next four years.

If this Committee believes that a phase-out, rather than immediate repeal, of the 30% withholding tax is necessary for foreign policy purposes, then we believe that, in order to provide no less access to foreign capital markets than is presently available, the resourcing of income rules, contained in Section 141, should be postponed until the withholding tax has been completely repealed.

CONCLUSION

The Chamber of Commerce of the United States commends the Chairman for holding hearings on this important issue and urges that H.R. 3025 be included in the Conference Report on H.R. 4170. We believe that the complete repeal of the 30 percent withholding tax on interest paid to foreign persons, which this bill provides, should be effective immediately in order to provide access to foreign capital markets for U.S. borrowers.

Mr. JENKINS. Thank you, Mr. White.

The committee will have to stand in recess until about 3:15, until we can go vote, and we will get back to you, Mr. Donaldson, a little bit later.

[A brief recess was taken.]

Mr. PICKLE [presiding]. The Chair will ask that the hearing continue now.

As you know, we are in the midst of a vote, and we may have some additional votes that could follow in quick order. But we are going to continue now.

As I understand it, in this particular panel, Mr. Butcher and Mr. McFarland have testified, is that correct?

Mr. WHITE. And Mr. White.

Mr. PICKLE. So now we are here to hear from Mr. Donaldson and/or Mr. Bushey, is that correct?

Mr. BUSHEY. Yes, sir.

Mr. PICKLE. Mr. White, have you testified?

Mr. WHITE. Yes; I have.

Mr. PICKLE. Now we receive testimony from Mr. John Donaldson, who is treasurer of the Avon Products, Inc.

Mr. Donaldson, would you proceed, sir?

STATEMENTS OF JOHN E. DONALDSON, JR., VICE PRESIDENT AND TREASURER, AVON PRODUCTS, INC.; AND RICHARD K. BUSHEY, VICE PRESIDENT AND CONTROLLER, SOUTHERN CALIFORNIA EDISON CO.

Mr. DONALDSON. Thank you, Mr. Chairman. I am John Donaldson, vice president and treasurer of Avon Products, Inc. With me today is Richard K. Bushey, vice president and controller of the Southern California Edison Co. We are testifying on behalf of 60 American companies. These companies represent a broad, geographically diverse cross section of U.S. industrial and financial enterprises. They range from substantial multinationals to medium sized companies whose business is entirely domestic. As such, these companies are broadly representative of the American private sector.

Since 1980, corporations such as these have raised almost $39 billion in the capital markets outside of the United States. Each of these 60 corporations has been brought together today by a common concern. Our concern is that our continued favorable access to the foreign capital markets may be inadvertently jeopardized by recent Government initiatives. Two of these are legislative, the tax reform bill of 1984 and the deficit reduction tax bill, also of 1984.

In addition to these legislative initiatives, our concern is further heightened by the recent challenges by the IRS to the existing Netherlands Antilles finance subsidiaries and to the uncertainty surrounding the renegotiation of the United States-Netherlands Antilles protocol. Individually, each of these initiatives is sufficient to impair materially our access to the Eurocurrency capital markets.

These markets are important to us. Over the past 5 to 10 years they have become a very significant source of funds for the American private sector. In 1978 U.S. corporations raised $1.4 billion in the Eurodollar bond market. This activity is now running at a much more significant annualized rate of $18 billion. It is also important to note that these markets are significant in a relative as well as absolute sense due to the fact that in recent years American corporations have turned to the overseas capital markets to provide for as much as 28 percent of their funding requirements.

The importance of the Eurocurrency capital markets is due to two simple reasons. First, they represent a source of funds which is distinct and separate from the domestic markets. Second, they provide a lower cost of funds. Intermediate maturity funds can be raised generally at one-quarter- to three-quarters-percent below that of the domestic alternative.

At the present time, our primary albeit indirect route to access the overseas capital markets on a withholding tax exempt basis is through the use of a special purpose finance subsidiary established in the Netherlands Antilles. This vehicle appears to be at risk for the reasons I mentioned just a moment ago.

Although we anticipate satisfactory renegotiation and ratification of the United States-Netherlands Antilles tax treaty, the outcome is still uncertain. Some district offices of the Internal Revenue Service have recently taken action with regard to the application of withholding tax on interest paid on Eurobonds. These actions could have a substantial and adverse effect on Eurobonds already outstanding as well as on future borrowings.

Additionally, the recharacterization of interest income rules found in both the House and the Senate bills generally restrict the ability to credit Netherlands Antilles tax against domestic taxes. In this event, the Netherlands Antilles taxes will become an incremental cost to the borrower which would eliminate all or substantially all of the savings afforded by borrowing overseas.

Therefore, in the absence of some form of direct access, these bills could disrupt the American capital markets and increase interest rates.

There are three forms of direct access which have been proposed. One is an immediate, broad access which would eliminate U.S. withholding taxes on all interest paid to foreign persons and as such would eliminate the need for a Netherlands Antilles finance subsidiary. Second, the Senate bill calls for a phased in broad access to the Eurocurrency capital markets. It would call for a reduction from the present 30 percent level of withholding tax to zero by 1988. However, during this period, the interest recharacterization rules found in the Senate bill as well as the House bill would effectively eliminate access until July 1988.

Last, a narrow access proposal which would eliminate withholding taxes on specifically targeted Eurobond offerings, those of U.S. corporations, Treasury, and Government agencies, has been proposed, but this proposal would preserve the withholding tax on interest paid to foreign persons on domestically offered securities.

We strongly support any measure which will preserve unimpeded access to the overseas capital markets. Of the various solutions offered, we very much prefer the narrow access proposal which would allow for specifically targeted U.S. Eurobond issues.

We support this narrow access proposal because it would preserve our vitally important access to the Eurocurrency capital markets, it would maintain the cost advantages that we enjoyed in past years. It would also simplify our funding process by eliminating the need for a Netherlands Antilles finance subsidiary. Additionally, it would also be similar to the approach used in other major industrialized countries such as Germany and Japan and be quite similar to the recently announced plans of the United Kingdom.

As such, we believe it is the most effective solution.

Thank you.

[The prepared statement follows:]

Statement of

John E. Donaldson, Jr.
Vice President and Treasurer
Avon Products, Inc.

Richard K. Bushey
Vice President and Controller
Southern California Edison Company

On Behalf of

H.F. Ahmanson & Company
American Cyanamid Company
Arizona Public Service Company
Avon Products, Inc.
Baker International Corporation
Baxter Travenol Laboratories, Inc.
Becton Dickinson and Company
Beneficial Corporation
The Black & Decker Manufacturing Company
Campbell Soup Company
CBS Inc.
CIGNA Corporation
The Coca-Cola Company
Colgate-Palmolive Company
Crown Zellerbach Corporation
Dart & Kraft, Inc.
Digital Equipment Corporation
Duke Power Company
Florida Power & Light Company
General Electric Corporation
General Mills, Inc.
Georgia-Pacific Corporation
Gould Inc.
Great Western Financial Corporation
Gulf States Utilities Company
Hercules Incorporated
Hewlett-Packard Company
Hospital Corporation of America
Household International, Inc.
Illinois Power Company
McDonald's Corporation
J.P. Morgan & Co. Incorporated
North American Philips Corporation
Pacific Gas and Electric Company
J.C. Penney Company, Inc.
PepsiCo, Inc.
Pfizer, Inc
Philadelphia Electric Company
Philip Morris Incorporated
PPG Industries, Inc.
The Prudential Insurance Company of America
Public Service Electric and Gas Company
Republic Steel Corporation
R.J. Reynolds Industries, Inc.
The Rockefeller Group, Inc.
Security Pacific Corporation
Southeast Bank, N.A.
Southern California Edison Company
Sterling Drug Inc.
Texaco Inc.
Textron Inc.
The Timken Company
Transamerica Financial Services
Transco Energy Company
Tribune Company
US WEST, Inc.
Wells Fargo & Company
Xerox Corporation

ON H.R. 3025 AND H.R. 4029

Before the
Committee on Ways and Means
United States House of Representatives
May 1, 1984

Mr. Chairman:

My name is John E. Donaldson, Jr. and I am Vice President and Treasurer of Avon Products, Inc. With me is Richard K. Bushey, Vice President and Controller of Southern California Edison Company who is here on behalf of H. Frederick Christie, Executive Vice President and Chief Financial Officer of that company. We are testifying on behalf of the 58 American companies identified in Exhibit I. Those corporations represent a broad cross-section of American industrial and financial enterprises from geographically diverse areas of the United States. Moreover, they range from substantial multinational corporations to small and medium-sized corporations whose business is entirely domestic in nature. Overall, therefore, they can be viewed as being broadly representative of the American private sector. In the period commencing January 1980, corporations such as these raised the equivalent of $38.9 billion in capital markets outside the United States.

These corporations have been brought together by a common concern that their access to vitally important overseas fixed income investors may be jeopardized by (1) the Tax Reform Bill of 1984, H.R. 4170, as approved by the House of Representatives (the "House Bill") and the Deficit Reduction Tax Bill of 1984, as approved by the Senate (the "Senate Bill"), (2) recent challenges of existing Netherlands Antilles finance subsidiaries by regional offices of the Internal Revenue Service and (3) the uncertainty relating to the renegotiation of the U.S./Netherlands Antilles protocol. Individually, each of these initiatives is sufficient to materially impair U.S. corporate access to the Eurocurrency capital market. Combined, we view them as a threat to a source of funds which has grown from being incidental only five or ten years ago to one which, if terminated, would materially and negatively impact the flow of investment funds to the American private sector, and therefore jeopardize its financial health.

We believe that the most effective means of preserving access to the Eurocurrency capital market is by immediately and completely eliminating U.S. withholding tax on Eurobonds issued by U.S. corporations as well as on other specifically targeted Eurobond issues including, if appropriate, issues by the U.S. Treasury and its agencies. This structure would be consistent with the withholding tax practices of virtually every major industrialized country and would preserve the cost advantages of accessing the Eurocurrency capital market without utilizing Netherlands Antilles finance vehicles. We believe that this result can best be accomplished by an approach similar to that espoused in H.R. 4029.

Relevance of Overseas Capital Markets

Corporate issuers are attracted to the Eurodollar bond market for two simple reasons: first, it represents an incremental source of funds which is separate and distinct from domestic capital markets and second, it has provided intermediate maturity funds at rates which have usually been between ¼ and ¾ of 1% below the cost of funds available in domestic markets (see Exhibit II).

A factor contributing to these conditions has been and remains the upward pressure on interest rates in the U.S. resulting from the Treasury's rapidly increasing funding requirements (see Exhibit III). Higher interest rates have given U.S. corporations a strong incentive to look elsewhere for funds. The Eurodollar bond market has grown to a point at which it rivals the domestic corporate market in size (see Exhibit IV). The funds raised by American corporations in these markets rose from $1.4 billion in 1978 to $14.5 billion in 1982. The dip to $7.5 billion in 1983 has been reversed by a climb to an $18 billion annual rate of issuance in the first quarter of 1984 (see Exhibit V).

(Continued)

(Continued)

Overseas capital has become an integral source of funds for American corporations, and has accounted for as much as 28% of total funds raised during recent years (see Exhibit VI).

Reasons for Concern

At the present time, the primary route for the private sector to access the Eurocurrency capital market on a withholding tax exempt basis is through special purpose financing subsidiaries established in the Netherlands Antilles. However, the U.S. Treasury Department is presently renegotiating the U.S./Netherlands Antilles tax treaty. Separately, recent actions taken by district offices of the Internal Revenue Service with regard to the application of withholding tax to interest paid on Eurobonds could have a substantial and adverse effect on those U.S. corporations which have currently outstanding Eurobonds issued since 1974 and on future borrowings in the Eurobond market. At the same time, passage of the House Bill and the Senate Bill serves to heighten our concern that access to overseas capital markets may be inadvertently terminated under such legislation. Under the two bills, corporate users of the Eurocurrency capital market will be confronted by a series of impediments to access to overseas investors regardless of whether such access is indirect via Netherlands Antilles subsidiaries or direct via targeted offerings.

Indirect Access Via N.V. Subsidiaries. The U.S./Netherlands Antilles protocol is in the process of being renegotiated and while we understand that it will be drafted in a manner which preserves access, we have no assurance that the negotiations will be completed or that the treaty will be ratified. Even if the treaty itself allows continued access, the recharacterization of interest income contained in both the House Bill and the Senate Bill would effectively terminate access for most borrowers. Currently, use of an N.V. subsidiary results in an annual Netherlands Antilles tax which ranges from 0.54% to more than 1.00% of the principal amount of bonds issued. Both the House Bill and the Senate Bill generally restrict the ability to credit this tax against domestic taxes. In this event, taxes paid to the Antilles government would constitute an incremental cost to the borrower.

As is evident in Exhibit II, very few corporations have enjoyed net cost of money savings on Eurobonds in excess of 0.54%. Thus, the impact of the two Bills would be to eliminate all or substantially all of the savings resulting from borrowing in overseas capital markets and would therefore sharply reduce the volume of capital that could economically be raised overseas.

Therefore, in the absence of some form of direct access as set forth below, both the House Bill and the Senate Bill could disrupt American capital markets and increase domestic interest rates.

Direct Access Without N.V. Subsidiaries. There are three forms of direct access legislation which have been proposed in the House and the Senate and which would make it unnecessary to employ N.V. subsidiaries to access overseas investors. Two forms of the legislation are broad in nature and one is narrow.

> *Immediate Broad Access.* H.R. 3025 would, effective its date of enactment, eliminate U.S. withholding taxes on all interest paid to foreign persons. Netherlands Antilles subsidiaries no longer would be utilized.

(Continued)

(Continued)

Phased-in Broad Access. The Senate Bill would reduce the 30% withholding tax to 5% effective its date of enactment and would then reduce it gradually to zero in July of 1988. Thereafter, in substance it would be the same as H.R. 3025. However, as stated above, the Bill contains the interest recharacterization rules which would effectively eliminate access.

Narrow Access. As presently drafted, H.R. 4029 would eliminate U.S. withholding taxes only on specifically targeted Eurobond offerings issued by U.S. corporations and the U.S. Treasury and its agencies. It would *not* eliminate withholding tax on interest paid to foreign persons on domestically offered securities.

Recommendation

The House Bill and the Senate Bill would effectively close off access to overseas markets for the vast majority of U.S. corporations because such corporations would be required either (i) to absorb the withholding tax on interest paid with respect to Eurobonds, or (ii) to generate substantial tax liabilities in the Netherlands Antilles which, in the future, might not be creditable against their U.S. tax liabilities.

We support any measure which will preserve unimpeded access to the Eurocurrency capital market. Of the various solutions which have been proposed, we strongly prefer an approach similar to that set forth in H.R. 4029 which would eliminate U.S. withholding tax on interest paid on specifically targeted Eurobond issues. This structure would be similar to that which exists in virtually every major industrialized country, including Germany and Japan. Such countries impose a withholding tax on interest paid on domestic securities but allow certain targeted Eurobond issues to be sold externally free of withholding tax. In fact, in its recently announced budget, the United Kingdom adopted a structure similar to that contained in H.R. 4029.

The Eurocurrency capital market has provided a vital and growing source of needed capital for U.S. industries for the past decade. It is critical that unimpeded access to this market be maintained. We believe that elimination of U.S. withholding tax on interest paid on specifically targeted Eurobond issues, that is, narrow access, (i) would maintain the necessary access, (ii) would preserve cost advantages of the Eurocurrency capital market, (iii) would most enhance Treasury revenues, (iv) would achieve these objectives without the need for Netherlands Antilles finance vehicles, and (v) would not require the United States to adopt a structure which would differ from that in virtually every major industrialized country. As such, we believe that it is the most effective solution to the problem of providing direct access to overseas sources of capital.

Thank you.

Exhibit I

Represented American Corporations

H.F. Ahmanson & Company
3731 Wilshire Boulevard
Los Angeles, California 90010

American Cyanamid Company
One Cyanamid Plaza
Wayne, New Jersey 07470

Arizona Public Service Company
411 North Central Avenue
Phoenix, Arizona 85036

Avon Products, Inc.
9 West 57th Street
New York, New York 10019

Baker International Corporation
500 City Parkway West
Orange, California 92668

Baxter Travenol Laboratories, Inc.
One Baxter Parkway
Deerfield, Illinois 60015

Becton Dickinson and Company
Mack Centre Drive
Paramus, New Jersey 07652

Beneficial Corporation
Beneficial Building
1100 Carr Road
Wilmington, Delaware 19899

The Black & Decker Manufacturing Company
701 East Joppa Road
Towson, Maryland 21204

Campbell Soup Company
Campbell Place
Camden, New Jersey 08101

CBS Inc.
51 West 52 Street
New York, New York 10019

CIGNA Corporation
One Logan Square
Philadelphia, Pennsylvania 19103

The Coca-Cola Company
310 North Avenue N.W.
Atlanta, Georgia 30313

Colgate-Palmolive Company
300 Park Avenue
New York, New York 10022

Crown Zellerbach Corporation
One Bush Street
San Francisco, California 94104

Dart & Kraft, Inc.
2211 Sanders Road
Northbrook, Illinois 60062

Digital Equipment Corporation
146 Main Street
Maynard, Massachusetts 01754

Duke Power Company
422 South Church Street
Charlotte, North Carolina 28242

Florida Power & Light Company
9250 West Flagler Street
Miami, Florida 33102

General Electric Corporation
3135 Easton Turnpike
Fairfield, Connecticut 06431

General Mills, Inc.
9200 Wayzata Boulevard
Minneapolis, Minnesota 55440

Georgia-Pacific Corporation
133 Peachtree Street N.E.
Atlanta, Georgia 30303

Gould Inc.
10 Gould Center
Rolling Meadows, Illinois 60008

Great Western Financial Corporation
8484 Wilshire Boulevard
Beverly Hills, California 90211

Gulf States Utilities Company
350 Pine Street
Beaumont, Texas 77704

Hercules Incorporated
Hercules Plaza
Wilmington, Delaware 19894

Hewlett-Packard Company
3000 Hanover Street
Palo Alto, California 94304

Hospital Corporation of America
One Park Plaza
Nashville, Tennessee 37203

Household International, Inc.
2700 Sanders Road
Prospect Heights, Illinois 60070

Illinois Power Company
500 S. 27th Street
Decatur, Illinois 62525

McDonald's Corporation
McDonald's Plaza
Oak Brook, Illinois 60521

J.P. Morgan & Co. Incorporated
23 Wall Street
New York, New York 10015

North American Philips Corporation
100 East 42nd Street
New York, New York 10017

Pacific Gas and Electric Company
77 Beale Street
San Francisco, California 94106

(Continued)

Exhibit I (Cont.)

J.C. Penney Company, Inc.
1301 Avenue of the Americas
New York, New York 10019

PepsiCo, Inc.
700 Anderson Hill Road
Purchase, New York 10577

Pfizer, Inc.
235 East 42nd Street
New York, New York 10017

Philadelphia Electric Company
2301 Market Street
Philadelphia, PA 19101

Philip Morris Incorporated
120 Park Avenue
New York, New York 10017

PPG Industries, Inc.
One PPG Place
Pittsburgh, Pennsylvania 15272

The Prudential Insurance Company
of America
Prudential Plaza
Newark, New Jersey 07101

Public Service Electric and Gas Company
80 Park Plaza
Newark, New Jersey 07101

Republic Steel Corporation
25 West Prospect Street
Cleveland, Ohio 44115

R.J. Reynolds Industries, Inc.
1100 Reynolds Boulevard
Winston-Salem, North Carolina 27102

The Rockefeller Group, Inc.
1230 Avenue of the Americas
New York, New York 10020

Security Pacific Corporation
333 S. Hope Street
Los Angeles, California 90071

Southeast Bank, N.A.
1 Southeast Financial Center
Miami, Florida 33131

Southern California Edison Company
2244 Walnut Grove Avenue
Rosemead, California 91770

Sterling Drug Inc.
90 Park Avenue
New York, New York 10016

Texaco Inc.
2000 Westchester Avenue
White Plains, New York 10650

Textron Inc.
40 Westminster Street
Providence, Rhode Island 02903

The Timken Company
1835 Dueber Avenue, S.W.
Canton, Ohio 44706

Transamerica Financial Services
1150 South Olive Street
Los Angeles, California 90015

Transco Energy Company
2800 Post Oak Boulevard
Houston, Texas 77056

Tribune Company
435 North Michigan Avenue
Chicago, Illinois 60611

US WEST, Inc.
7800 East Orchard Road
Englewood, Colorado 80111

Wells Fargo & Company
420 Montgomery Street
San Francisco, California 94163

Xerox Corporation
P.O. Box 1600
Stamford, Connecticut 06904

Exhibit II

Illustrative Cost Savings for U.S. Corporations in the Eurodollar Bond Market[1]

Offering Date	Guarantor	Amount ($ Millions)	Maturity (Years)	Net Cost of Money Savings Versus Domestic Market (in basis points)
1984 (through April 20)				
4/17	GTE Finance Corporation	$ 75	3	55
4/16	Morgan Guaranty Trust Company of New York	150	5	47
4/11	Communications Satellite Corporation	100	7	65
4/11	Citicorp	100	3	70
4/06	ITT Financial Corporation	100	3	57
3/28	American Savings & Loan Association	125	5	64
3/08	Illinois Power Company	100	8	35
3/08	Digital Equipment Corporation	150	5	23
3/07	International Paper Company	75	7	33
3/02	Texas Instruments Incorporated	150	7	45
2/29	Gulf & Western Industries, Inc.	100	5	2
2/27	Shearson/American Express Inc.	100	10	10
2/09	Alaska Housing Finance Corporation	100	10	66
2/08	Norwest Corporation	50	7	7
2/02	Security Pacific Corporation	100	8	22
1/18	Beneficial Corporation	100	7	11
1/17	Macy Credit Corp.	100	7	58
1/17	Sears, Roebuck and Co.	150	7	58
1983				
11/30	Security Pacific Corporation	100	5	12
11/14	Sears, Roebuck and Co.	125	5	33
10/04	Sears, Roebuck and Co.	150	10	22
9/21	General Motors Acceptance Corporation	100	7	62
9/21	Citicorp	100	7	28
9/20	Pacific Gas and Electric Company	75	8	47

(Continued)

Exhibit II (Cont.)

Offering Date	Guarantor	Amount ($ Millions)	Maturity (Years)	Net Cost of Money Savings Versus Domestic Market (in basis points)
6/20	Levi Strauss & Co.	75	7	29
6/15	Richardson-Vicks Inc.	125	10	8
6/15	Revlon, Inc.	125	7	52
6/03	Security Pacific Corporation	100	5	32
5/13	Manufacturers Hanover Ltd.	50	5	12
5/13	Manufacturers Hanover Ltd.	100	7	48
5/09	Weyerhaeuser Real Estate Company	50	7	20
4/26	Southern California Edison Company	75	7	45
4/19	Merrill Lynch & Co., Inc.	200	7	14
4/19	Enserch Corporation	100	10	28
3/24	Crocker National Bank	75	5	21
3/17	Honeywell Inc.	100	7	15
3/10	American Express Overseas Credit Corporation Limited	100	7	77
2/28	Prudential Funding Corporation	100	10	23
2/04	Texaco Inc.	150	7	68
1/26	IC Industries, Inc.	75	7	78
1/25	The Coca-Cola Company	100	9½	84
1/24	McDonald's Corporation	75	10	116
1/20	General Electric Credit Corporation	100	8½	81
1/19	Standard Oil Company (Indiana)	50	7	54
1/19	Security Pacific Corporation	100	4	28
1/18	Sears, Roebuck and Co.	150	8	31
1/18	Avon Products, Inc.	100	9½	63
1/18	General Motors Acceptance Corporation	200	7	31
1/17	The Continental Group, Inc.	75	10½	48
1/13	Time Incorporated	100	7	28

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[1] Excludes zero coupon issues, issues with warrants, convertible debentures and floating rate notes. The net cost of money (after gross underwriting spread) is calculated on a semiannual equivalent basis. On retractable issues, the initial refixing rate is considered to be the maturity.

Exhibit III

Relative Issuance of Treasury, Mortgage Related and Corporate Debt in the U.S. Public Bond Market 1978-1983

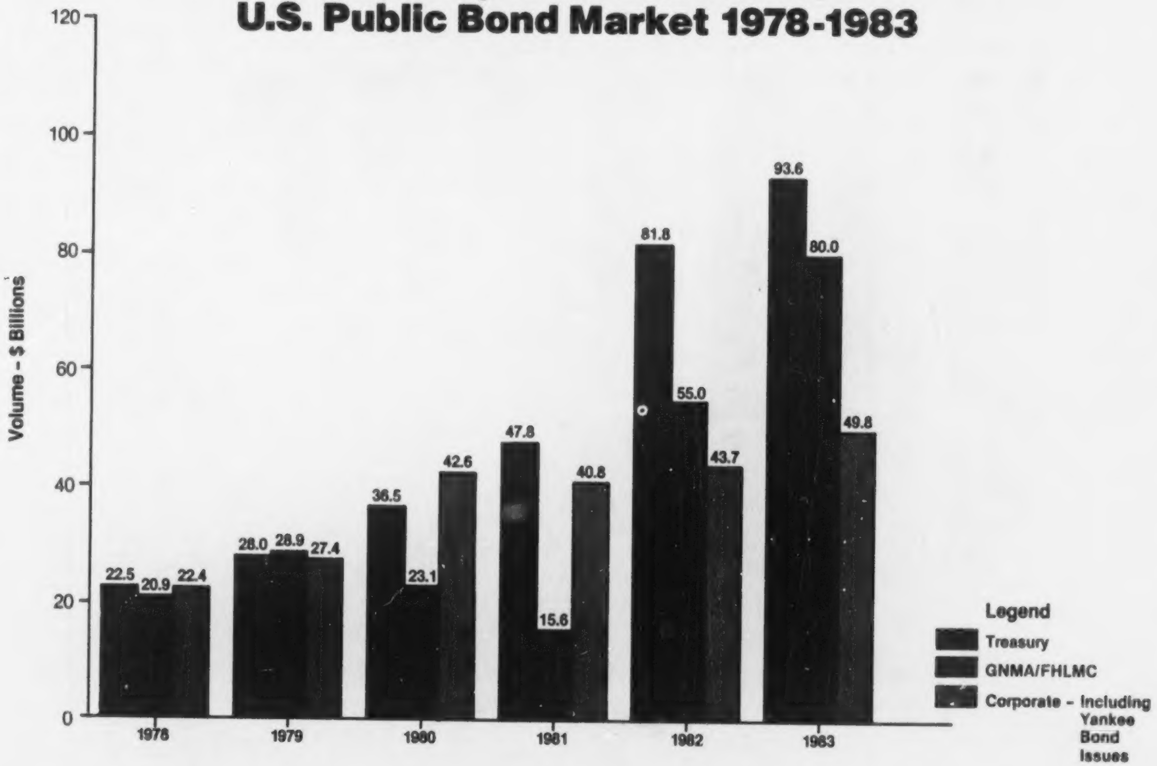
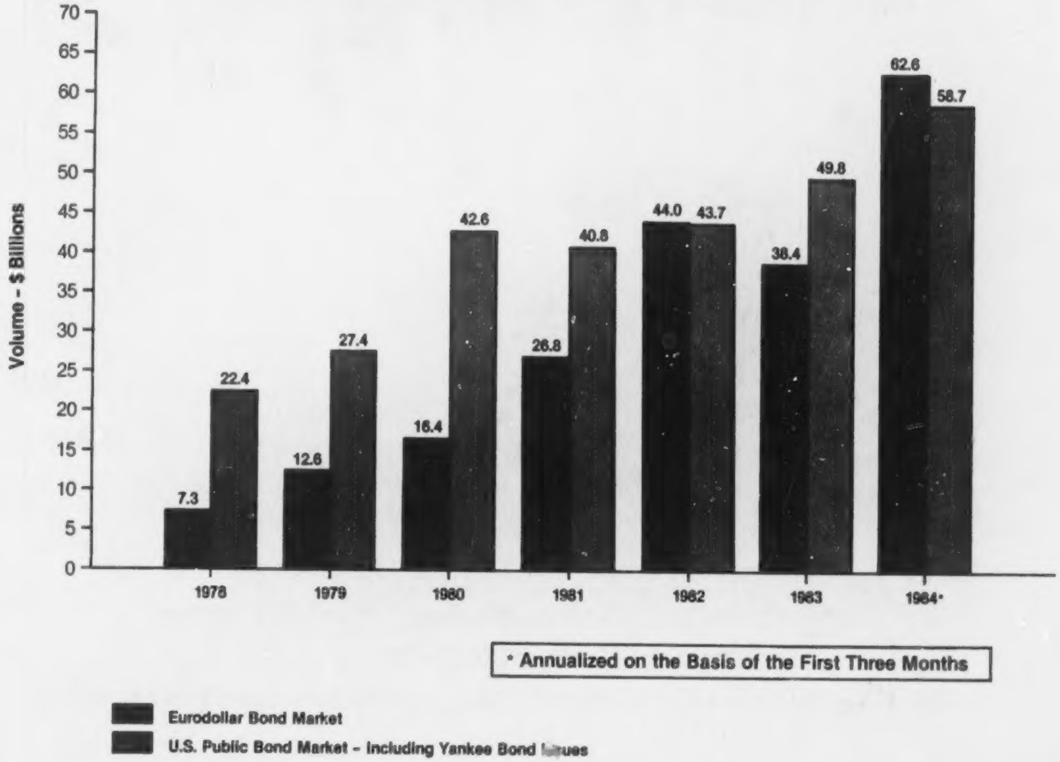


Exhibit IV

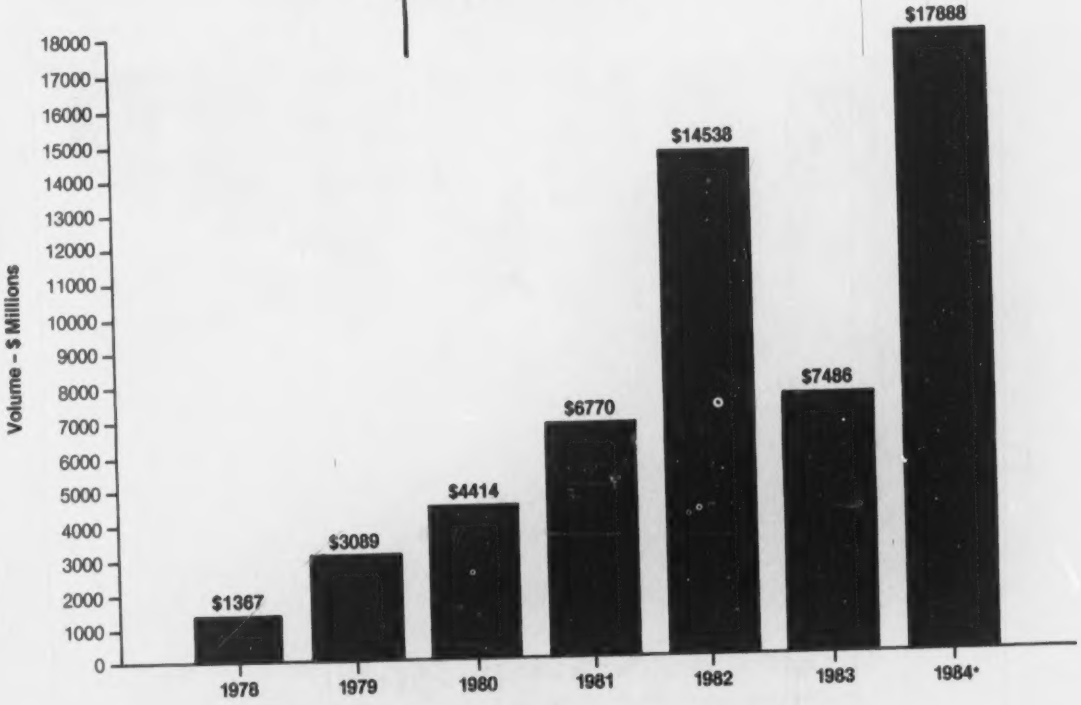
New Issues by all Borrowers in the U.S. Public and Eurodollar Bond Markets



* Annualized on the Basis of the First Three Months

Exhibit V

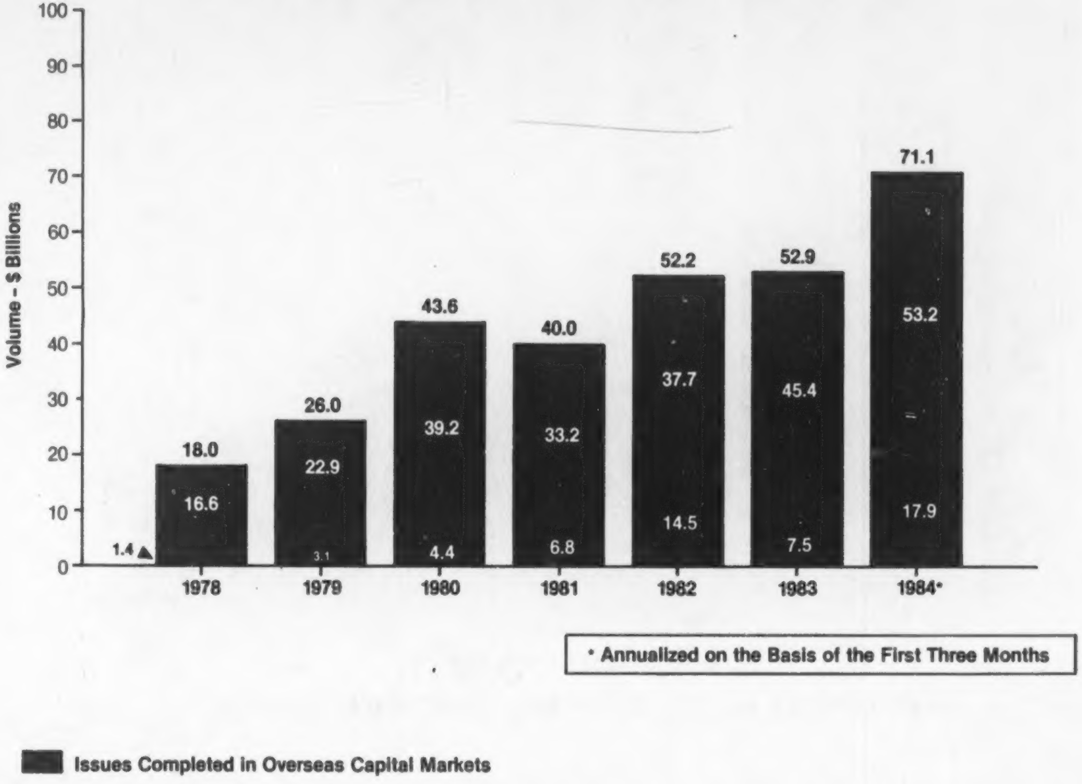
Eurobond and Foreign Bond Issues by U.S. Corporations



* Annualized on the Basis of the First Three Months

Exhibit VI

New Issues by American Corporations in the U.S. and Overseas Capital Markets



* Annualized on the Basis of the First Three Months

Mr. PICKLE. Now, Mr. Bushey, do you have an additional statement?

Mr. BUSHEY. I do not have additional comments, no.

Mr. PICKLE. Do any of the panelists have comments to add in addition to what has been stated?

Mr. CONABLE. Including comments about the others' papers.

Mr. PICKLE. Well, I want to ask one question, to any of the panelists.

Would H.R. 3025, the Conable-Gibbons bill, or H.R. 4029, the Barnard bill, have the same effect on the interest rates available to U.S. companies in the Eurobond market relative to the domestic interest rate? Would they have the same effect?

Mr. DONALDSON. Mr. Chairman, I do believe that H.R. 3025, which would allow for existing offerings, the existing offerings in the marketplace right now as well as new issues be exempt from the withholding tax would mean that the interest rate differentials that we now enjoy would more rapidly disappear than under H.R. 4029 which would allow the withholding tax exemption to apply only to new issues.

Mr. PICKLE. Mr. White, did you want to comment on that?

Mr. WHITE. Yes: if I may. I agree basically with the statement that what we believe would happen is that while the preferential advantage that large U.S. corporations have in the Eurobond market today would be eroded by the broad approach, we believe that that would be offset by lower interest rates in the United States, assuming there are a finite amount of funds in both markets and a finite amount of borrowings in both markets. The amount of the interest rate in the United States would decline, which would be favorable to smaller businesses in the United States.

Mr. PICKLE. You are both saying it would have some difference in the interest rate?

Mr. WHITE. Yes, sir.

Mr. DONALDSON. For the traditional Euromarket borrowers, I believe that H.R. 4029 would preserve the historical interest rate differentials more than H.R. 3025 would.

Mr. PICKLE. Well, I thank you, and I thank the panelists very much.

Oh, I beg your pardon.

Mr. Butcher.

Mr. BUTCHER. Yes; I was going to add again that one of the concerns of not having the U.S. Government coming into the market is that the U.S. Government will become a benchmark for a lot of the corporate issues overseas. To the extent that it does, not only does the Government benefit from lower borrowing costs, but you have a more liquid market and a more efficient market across the board. And although there is some argument that that will mean that the Government will have funds substituted into Government securities that may come out of bank deposits and other types of things where you have a more liquid market, more people are willing to participate, and I think we will see better rates for everybody overall over the long run.

Mr. CONABLE. So you favor the broader bill?

Mr. BUTCHER. Yes, very much so.

Mr. PICKLE. The Gibbons-Conable bill.

Well, I thank you, Mr. Butcher, and I appreciate your comments. I thank all the panelists.

Now, the Chair calls Mr. J. Thomas Stephens, Mr. Jack B. Spring, Mr. Robert Ragland, and Mr. Steven Hannes.

If you gentlemen would come and take your position at the witness table.

Mr. Stephens, chairman of the Mortgage-Backed Securities Division and member, board of directors of the Public Securities Association.

Mr. STEPHENS. Thank you, Mr. Chairman. With me today is also——

Mr. PICKLE. Then there is Jack Spring, executive vice president for finance and administration, National Car Rental; and then Mr. Robert Ragland, director of taxation, National Association of Manufacturers; and then Mr. Steven Hannes, chairman, International Tax Specialty Group of Touche Rosse.

Now, Mr. Stephens, if you would care to present your statement.

Let me interrupt you just a minute. We have another vote on.

Let's proceed, Mr. Stephens, with your testimony. We may have to interrupt again, but we will do the best we can. We are sorry.

STATEMENTS OF J. THOMAS STEPHENS, CHAIRMAN, MORTGAGE-BACKED SECURITIES DIVISION, AND MEMBER, BOARD OF DIRECTORS, PUBLIC SECURITIES ASSOCIATION; AND JON S. CORZINE, PARTNER, GOLDMAN, SACHS & CO., CHAIRMAN, GOVERNMENT AND FEDERAL AGENCIES DIVISION, AND MEMBER, BOARD OF DIRECTORS, PUBLIC SECURITIES ASSOCIATION

Mr. STEPHENS. Thank you, Mr. Chairman. With me today is also Mr. Jon Corzine, also representing the PSA.

Mr. CORZINE. Mr. Chairman, my name is Jon Corzine. I am a partner of Goldman Sachs and chairman of PSA's Government and Federal Agency Division as well as chairman of the Primary Dealers Committee. This group is comprised of the 37 banks and dealers who are officially recognized by the Federal Reserve and charged with underwriting and distributing the national debt.

We as representatives of PSA, appreciate this opportunity to speak briefly on the subject of the 30-percent withholding tax. Our written presentation makes our position clear, and I respectfully request that it be included as a part of the hearing.

Let me reiterate, we strongly support H.R. 3025 as a bill which, in our view, is in the Nation's interest. We believe that the Gibbons-Conable approach is the best alternative among those before Congress. This bill, in an unvarnished fashion, will promote four commonsense objectives: broad competitive markets for Treasury and public sponsored debt; lower interest rates; lower budget deficits; and economic growth.

Reasonable analysts can argue the degree to which these objectives will be promoted by full repeal of the 30-percent withholding tax, but it seems clear to the primary dealer community that more buyers mean higher prices and lower interest rates than would otherwise be the case.

Other things being equal, expanding the universe of buyers for U.S. debt to include foreign private investors appears, in our judgment, to be a definite positive for the depth and breadth of the marketplace. Equally important from this perspective, lower financing cost diminishes the Treasury's interest expense, and that in itself reduces Treasury's presence in the credit markets.

Our experience overwhelmingly convinces us that private foreign investors are reluctant to incur the 30-percent withholding premium involved in purchasing U.S. Treasury and agency securities when other alternatives exist. PSA believes repeal will remove this prejudice and allow Treasury and agencies to compete in a free market context for scarce investor dollars.

As important as expanding the breadth and depth of the Treasury and agency debt markets may be, the more critical objective of reducing the budget deficit is also promoted by repeal. As we state in our written presentation, and as Treasury has conservatively estimated, repeal of foreign withholding will produce net positive revenue flows of between $35 million and $50 million per year. This revenue benefit, plus the relative interest expense savings promoted by broader markets, gives strong financial purpose to the objective of H.R. 3025.

In short, we would note that a savings of one-tenth of 1 percent on $1 trillion of U.S. debt would be $1 billion in savings annually.

Finally, the community of primary dealers endorses the views Mr. Stephens will now outline with regard to the benefits of repeal of foreign withholding as it impacts the housing industry and its general support for sustained economic growth.

Mr. STEPHENS. Mr. Chairman, my name is Tom Stephens. I am a senior vice president of Thomson McKinnon Securities in New York, and chairman of the PSA's Mortgage-Backed Securities Division. I am here today to tell you that the mortgage-backed securities dealer community shares the views just expressed by Mr. Corzine. We also support H.R. 3025 and believe it most advisable and particularly timely to repeal the 30-percent withholding in one step. In our view, this is the best of all the alternatives before Congress.

Up to this point, activity in the overseas market for government related mortgage-backed securities has been quite low. There is significant private foreign investor interest in U.S. mortgage-backed securities but, because of the 30-percent withholding tax, this form of investment has just not been competitive with other available securities trading in the Eurobond market which are not subject to this restriction.

Let me give you an example to illustrate why we feel so strongly about the potential overseas market for mortgage-backed securities. In June 1983, five different Ginnie Mae passthrough securities were listed on the Luxembourg Stock Exchange. Total sales resulting from this listing on a cumulative basis from June 1983 through March 1984 has been only $550 million. In Singapore sales have totaled merely $4 million since January 1984 listing.

On the other hand, this last month's Eurobond offerings of mortgage-backed securities through Netherlands Antilles subsidiaries by U.S. financial institutions with no withholding of 30-percent have totaled nearly $500 million, and all have been quick to sell out.

Obviously there is a significant foreign investor interest in quality mortgage-backed instruments without the 30-percent withholding.

We in the mortgage-backed securities dealer community believe that the total repeal of the 30 percent withholding tax will expand access to foreign capital and will greatly contribute to the establishment of more efficient means of financing residential housing, thereby promoting sustained economic growth in our housing industry and the Nation's economy.

More importantly, we believe that this repeal will lower borrowing costs for the individual home buyer. The mortgage-backed securities market is one of the fastest growing markets in the United States, and therefore is constantly in need of additional sources of investment funds to meet the rapidly expanding credit demands of our Nation's housing industry. This market provides the principal means by which thrift institutions and other mortgage originators are able to sell newly originated mortgages or other mortgages held in portfolio to raise capital to finance new mortgage loans.

It has been estimated that the total mortgage credit needs for 1983 for newly originated one to four family loans exceeded $190 billion. Over the next decade, it has been estimate that $4 trillion will be needed to finance housing in this country. One of the ways to satisfy this enormous demand for mortgage credit is to encourage broader access to housing credit markets from international sources of funds.

Enactment of H.R. 3025 would represent a significant positive step in this direction.

Thank you.

[The prepared statement follows:]

Statement of the Public Securities Association

INTRODUCTION

The Public Securities Association ("PSA") appreciates this opportunity to testify in support of H.R. 3025, a bill which would repeal the 30 percent withholding tax on U.S. issued securities purchased by foreign investors. We believe that enactment of H.R. 3025 will encourage significantly greater long-term foreign investment in the United States and improve access to the foreign capital markets by U.S. borrowers, particularly the U.S. Government and the federally sponsored agencies, as well as the government-related secondary mortgage market agencies, such as the Government National Mortgage Association, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

PSA is the national trade association which represents approximately 300 banks, dealers and brokers that underwrite, trade and distribute U.S. government and federal agency securities, mortgage-backed securities, and state and local government securities. All 37 primary dealers in government securities, as recognized by the Federal Reserve Bank of New York, are PSA members. In addition, included among our membership are all the nation's leading mortgage-backed securities dealers.

CURRENT LAW AND MARKET ENVIRONMENT

Under current law, income tax at the rate of 30 percent must be withheld on interest paid by U.S. borrowers to non-resident aliens and foreign corporations not doing business in the United States. This tax is generally collected by means of withholding by the person making the payment to the foreign recipient of the income. The tax law also provides a number of exemptions from this 30 percent tax on gross income. Most notably, interest from bank deposits and from original issue discount on obligations maturing in six months or less are exempt. Morover, the income of foreign governments from investments in the U.S. in bonds, stocks and other securities or from interest on bank deposits is generally exempt from U.S. tax. In addition to these statutory exemptions, various income tax treaties provide either for an exemption or a reduction rate of tax for U.S. source interest paid to foreign persons. The treaty exemptions are based on the assumption that the interest income will be taxed in the country of residency of the investor.

In order to avoid the 30 percent withholding provision it is common practice among prime U.S. corporate borrowers to establish a finance subsidiary in the Netherlands Antilles. Through this structure these corporate borrowers are able to claim the benefits of the tax treaty between the United States and the Netherlands, as extended to the Antilles. In 1982 domestic corporations took advantage of this structure by offering $43 billion securities in the Eurodollar market.

In addition to prime corporate borrowers, numerous sovereign credits issue debt obligations in the Eurobond market which are free of taxes withheld at the source. This freedom from withholding taxes may be based on a specific exemption for interest on specified foreign borrowings (as, e.g., in the case of Canada, France, the United Kingdom and Australia), on the absence of any withholding tax on interest (as, e.g., in the case of the Netherlands, Denmark and Finland) or on the use of foreign finance subsidiaries (as, e.g., in the case of Germany). Foreign countries whose issuers have borrowed in the Eurobond market without withholding tax include the following:

Algeria; Argentina; Australia; Austria; Brazil; Belgium; Canada; Chile; Colombia; Costa Rica; Denmark.

Finland; France; Germany; Greece; Hungary; Iceland; India; Indonesia; Israel; Iran; Ireland; Italy.

Japan; Korea; Luxembourg; Malaysia; Mexico; Netherlands; New Zealand; Norway; Papua New Guinea; Philippines; Portugal.

Singapore; South Africa; Spain; Sweden; Switzerland; Trinidad and Tobago; Thailand; United Kingdom; Venezuela; and Yugoslavia.

Borrowers in the Eurobond market also include international organizations (such as the World Bank and the Asian Development Bank) and multinational organizations (such as the European Investment Bank and the European Economic Community). These organizations also borrow free of the withholding tax.

THE U.S. TREASURY AND GOVERNMENT RELATED SECONDARY MORTGAGE MARKETS

The market in U.S. Treasury securities has experienced a tremendous amount of growth within the past six years. The net increase in privately held Treasury debt was $47 billion in 1978. By 1980 this figure was $75 billion, a 60% increase. In 1982 privately held Treasury debt increased by $152 billion while the increase in 1983 is estimated to be $188 billion, bringing the total amount of U.S. Treasury debt outstanding to over $1 trillion. During this period substantial growth was experienced by the government-related secondary mortgage market as well. The net increase in government-related secondary mortgage market securities (mortgage pool securities guaranteed by GNMA, FHLMC, FNMA and FHA) was $14 billion in 1978. By 1982, this figure increased by more than 250% to $50 billion. It is estimated that the net increase in government-related secondary mortgage market securities in 1983 was $77 billion.

FOREIGN INVESTMENT IN U.S. TREASURY AND GOVERNMENT RELATED SECONDARY MORTGAGE MARKET SECURITIES

Since 1980, net foreign investment has played a relatively minor role in the U.S. Treasury securities market. More to the point, our experience suggests that the vast majority of these investments were made by foreign central banks which are exempt from withholding taxes. Net private foreign investment constituted a mere 3 percent of the net increase of $75 billion in privately held Treasury debt outstanding in 1980. This percentage figure stayed roughly the same through 1983. It is estimated that, of the $188 billion increase in privately held Treasury debt in 1983, net private foreign investment comprised a meager $4.1 billion.

While private foreign investment has been slight, foreign market interest in the U.S. government securities market is apparent in the decision of the London International Futures Exchange to establish a U.S. Treasury bond future contract. They believe that this will be the vehicle most likely to succeed as a hedging device for the Eurobond trading community. The Singapore Stock Exchange is also in the process of developing a U.S. Treasury bill futures contract. Finally, it should be noted that a number of primary dealers are actively seeking to trade and distribute

U.S. government securities on a 24 hour basis, with extensive efforts focused in London.

Private foreign investment in government-related secondary mortgage market securities has been practically non-existent. Since 1978, private foreign investment in the net increase in these securities has been less than $1 billion annually. However, growing interest among foreign accounts in government-related secondary mortgage market debt investment is evident by the listing of GNMA pass-throughs on the Luxembourg Stock Exchange in June 1983 and the Singapore Stock Exchange in January 1984. In addition, it should be noted that the Finance Ministry of Japan recently ruled that GNMA securities are "securities" eligible for purchase and sale by Japanese securities dealers. Activity in these overseas markets has been quite low. For example, total sales resulting from the Luxembourg listing on a cumulative basis from June 1983 through March 1984 has been merely $550 million. In Singapore sales have totalled merely $4 million since January 1984. On the other hand, recent Eurobond offerings of mortgage-backed bonds through Netherland Antilles subsidiaries by U.S. financial institutions (e.g. Financial Corporation of America) have totaled nearly $500 million and all have been a sell-out on the day of their offerings. Clearly, there is significant foreign investor interest in quality mortgage-backed instruments. The volume of activity which took 9 months to accomplish in the Luxembourg listed securities (which are subject to the U.S. withholding tax) has taken merely 2 or 3 weeks for similar securities which are not subject to this restriction.

THE PUBLIC SECURITIES ASSOCIATION POSITION

PSA strongly supports H.R. 3025 as the best alternatives among the various proposals before the Congress which address the withholding issue. Our arguments in support of this position will focus on the positive implications of enactment of H.R. 3025 as it relates to the U.S. government and mortgage-backed securities markets. Before detailing our arguments in support of H.R. 3025, we will outline our views on other current withholding legislation.

A modified version of H.R. 3025 received the approval of the Senate Finance Committee on March 21, 1984 as part of the Deficit Reduction Act of 1984. The Senate Bill provides for a phase-down of the 30 percent withholding, whereby the tax will fall to 5 percent this year, 4 percent in 1985, 3 percent in 1986, 2 percent in 1987 and 1 percent in 1988. The tax would be reduced to zero in July 1988. This phase-down approach would not reduce the fixed administrative and operational costs inherent in maintaining the withholding system. These fixed costs which are not significant would continue to be incurred for 4 more years. More importantly, the benefits of repeal, which are discussed later in this statement, would in our view be unnecessarily deferred.

However, we strongly prefer the Senate Bill to H.R. 4209 introduced by Representative Doug Barnard, which is intended to simply remove the 30 percent withholding tax on U.S. corporate obligations targeted for sale to foreign investors. We oppose the Barnard Bill because it is not intended to broaden access by foreign investors to U.S. government securities or to the many forms of federally sponsored mortgage-backed securities. We hold this view cognizant of discussed amendments to the Barnard Bill which would repeal the withholding tax on primary issues, while maintaining it on purchases by foreign investors in the secondary market.

ARGUMENTS IN SUPPORT

Repeal will expand depth and breadth of market

In our view, the repeal of the 30 percent withholding tax on interest paid to foreign investors will facilitate borrowing in the foreign capital markets and will enable the U.S. government and the nation's mortgage credit institutions to diversify their sources of funds. This diversification should lead to better pricing terms on primary offerings as well as expand the depth and breadth of secondary markets. In many instances U.S. corporations have been able to borrow at lower rates of interest than would have been available in the U.S.

American debt obligations, burdened with this tax, must compete with securities sold in the Eurodollar bond market which are not subject to any so-called withholding tax. The net effect of the U.S. tax, in most cases, is to reduce the return to overseas investors on interest-bearing securities issued in the United States, in some cases up to one-half of one percent and potentially more depending upon reciprocal national treaties. This reduced return makes U.S. government and mortgage-backed securities decidedly uncompetitive with alternative investments available in the

Eurodollar bond market. The tax has created an insurmountable barrier to investment in U.S. government and mortgage-backed securities by most foreign private individuals and institutions. As a practical matter, our experience shows very limited distribution of these debt securities to foreign private sector investors as a direct result of this 30 percent withholding tax.

To illustrate the impact of this tax on foreign investments, we reference our earlier discussion of the volume of foreign investment activity in mortgage-backed securities in the European market and call your attention to a recent study of 45 Eurobond issues offered in 1982/83. The study revealed that Eurobond issues enjoyed an interest cost advantage relative to domestic credit of between .1 percent and 1.5 percent with the average savings estimated at .50 point. Enactment of H.R. 3025 would eliminate much or all of this advantage. Once free to acquire U.S. government and mortgage-backed securities in the secondary market, non-U.S. investors would no longer be prepared to pay a premium for U.S. Eurobond issues. Yield arbitrage would even out the two markets. Most significantly, it is reasonable to assume that rates in the U.S. debt markets might drop slightly or be held lower than otherwise as a result of an influx of foreign funds.

Enactment of H.R. 3025 will expand market for long-term securities

These current tax law provisions have clearly created an environment of incentives and restraints favoring the purchase of some investment instruments and restraining the purchase of others. In particular, the withholding tax encourages investment in short-term securities which are exempt from withholding, to the detriment of capital market investments. By definition, the supply of short-term funds is volatile and subject to change based on a variety of economic and non-economic developments. Since it is difficult to make long-term capital commitments based on potentially volatile short-term sources of funds, the withholding tax has the effect of discouraging long-term capital formation in the United States. Essentially, the withholding tax has left the U.S. as one of the only nations which has no legitimate way by which private foreign investors can acquire its long-term debt securities. This problem is all the more significant in the current environment of heavy U.S. debt financing. In addition, repeal of the withholding tax would assist the Treasury in achieving its goal of extending the average maturity of its marketable debt.

Positive revenue effects of H.R. 3025

In addition to the positive effects of expanding access to foreign capital, we share the view of the Treasury Department that the repeal of the foreign withholding tax will lead to measurable revenue gain for the Treasury. By making the employment of Netherlands Antilles finance subsidiaries unnecessary, enactment of H.R. 3025 would eliminate payments of Netherlands Antilles income tax made by such subsidiaries which, in turn, would eliminate the foreign tax credit taken for such taxes and thereby increase U.S. tax revenues. The magnitude of the revenues thus raised is difficult to quantify with certainty, largely because the Netherlands Antilles income tax varies with the finance subsidiaries' debt to equity ratio, use of proceeds, and other factors. Notwithstanding these information constraints, PSA believes that the Treasury Department's estimate of $35-50 million revenue gain is reasonable. In short, this bill will not only eliminate an existing restraint on access to foreign capital, but also contribute to the critical need for reducing the budget deficit.

Enactment of H.R. 3025 will promote the country's economic growth

By expanding the access of government related mortgage agencies to foreign capital the repeal of the 30 percent withholding tax will contribute to the establishment of more efficient means of financing residential housing, thereby promoting sustained growth in our housing industry and the nation's economy. Equally important, increasing the supply of funds available for borrowing should tend to lower borrowing costs for homebuyers.

The mortgage-backed securities market is one of the fastest growing markets in the U.S. and is therefore in need of additional sources of investment funds to meet the rapidly expanding credit demands of our nation's housing industry. This market provides the principal means by which thrift institutions and other mortgage originators are able to sell newly originated mortgages, or older mortgages held in portfolio, to raise capital to finance new mortgage loans. It has been estimated that the total mortgage credit need for 1983, for newly originated one to four family loans, exceeded $190 billion. Over the next decade it has been estimated that $4 trillion dollars will be needed to finance housing in this country. Encouraging broader access to housing credit markets from international sources of funds would contribute to satisfying this enormous demand for mortgage credit. Enactment of H.R. 3025 would represent a significant positive step in this direction.

CONCLUSION

By repealing the 30 percent withholding tax on private foreign investors the Congress will be removing an investment impediment which has reduced foreign investor participation in both the government and mortgage-backed securities markets. We strongly support H.R. 3025 as the best alternative of the various proposals before the Congress which address this issue. We share the view of the Administration that it is in our country's long-term interest to improve access to foreign capital markets because such access will represent an important element in achieving increased capital formation and sustained economic growth for the entire nation. PSA also believes that enactment of H.R. 3025 will decrease pressures on our domestic capital market to finance the federal budget deficit, promote investment in long-term U.S. government securities, lower borrowing costs for homebuyers and significantly expand the sources of credit available to the mortgage finance industry. We, therefore, urge the Congress to enact H.R. 3025.

Mr. PICKLE. I thank you, Mr. Stephens, and also for your statement, Mr. Corzine. I appreciate your having a concise statement.

Mr. Spring, we are going to recognize you.

Let me say at the beginning that we have a vote now, and if you could summarize in a short time, we might be able to receive your statement. But if you prefer, we will come back. We have two other witnesses after that.

Why don't you start, and we will stay with you for a while and then come back as soon as we can.

STATEMENT OF JOHN B. SPRING, EXECUTIVE VICE PRESIDENT OF FINANCE AND ADMINISTRATION, NATIONAL CAR RENTAL SYSTEM, INC., AND MEMBER, COMMITTEE ON CORPORATE FINANCE, FINANCIAL EXECUTIVES INSTITUTE

Mr. SPRING. Thank you, Mr. Chairman.

My name is John B. Spring. I am executive vice president of finance and administration for National Car Rental System and a member of the Committee on Corporate Finance of the Financial Executives Institute. The Financial Executives Institute is the professional association of more than 12,000 senior financial and administrative officers of over 6,000 organizations, large and small, throughout the United States and Canada, and it is on their behalf that I appear before you today.

In your deliberations, you have considered different proposals for dealing with the withholding tax on interest payments that presently is imposed on foreign lenders. Our objective in appearing here today is to register our support for legislation that would eliminate the 30-percent withholding tax on interest payments to foreign investors, thereby avoiding the need to employ special purpose financing subsidiaries when accessing otherwise cost-effective Eurobond financing.

The Eurobond market has provided a major source of funds for U.S. corporations, as evidenced by the significant annual issuance of debt securities through Netherlands Antilles finance subsidiaries over the past several years. Elimination of the 30-percent withholding tax would afford direct access by corporations to the Eurobond market, and as a result, would therefore allow the elimination of, first, the need to utilize special purpose financing subsidiaries; second, the costs of establishing and administering these subsidiaries; third, the payment of taxes to the Netherlands Antilles; and fourth, the potential uncertainty surrounding continued availability of capital from international markets due to periodic renegotiations of existing tax treaties.

We believe as a practical matter that borrowings are not made now in cases where withholding would apply. Accordingly, there would be no revenue loss to the Treasury, by elimination of the 30 percent withholding tax. In fact, there would be a substantial gain to the Treasury, estimated to be anywhere from $50 million to $150 million a year, since there would no longer be the necessity for taking a foreign tax credit for taxes paid to the Netherlands Antilles.

While there has been legislation proposed under section 141 of H.R. 4170 to disallow this tax credit against domestic taxes, this would be an attack on the symptom rather than the problem, and would simply make a bad situation worse.

Mr. PICKLE. Mr. Spring, our clock is running out, and we must recess the committee for approximately 10 minutes, and we will return.

If you two gentlemen can wait, we will be right back.

We will stand in recess for 10 minutes.

[A brief recess was taken.]

Mr. PICKLE. Would you please resume your seat and continue.

Let me say before you start that the Chair is going to insert for the record in its entirety the statement by Mr. Hannes and Mr. Ragland. We have pending a possible 15 votes on the suspension calendar which would take us 1½ to 2 hours. If we wait through all that in order to submit your testimony, with all the fuss and fury, you might have to wait until 5 o'clock.

So, let me ask if you can to summarize your statement. We regret that the time has run out like this, but we cannot help these things.

Now, Mr. Spring, if you will continue, please.

Mr. SPRING. I will try to summarize the important points in my commentary here today. I will pick up where I left off.

U.S. corporations would rather pay taxes to the United States if they have to pay them to anyone, and they have no taste for paying income tax to the Netherlands Antilles. Corporate treasurers continue to be concerned that they have to resort to arcane financial structures, such as NV subsidiaries, in order to obtain adequate financing, and it is not a small matter when you consider the dollars and the percent of volume that is handled this way.

From a public policy standpoint, it is clear to us that existing constraints to overseas markets should be removed, and we strongly believe that new and further constraints should not be put in their place. Repeal should be immediate and should not be hampered by a so-called phasein as suggested in the Senate bill. This would simply delay the effect of the repeal for no good purpose. At best, it would prolong a cumbersome and artificial financing device.

The more likely result, though, would be that it would effectively cut off overseas financing altogether until the phase-in period had passed. Such legislation which would have the practical effect of benefitting no one, would not be wise.

At these hearings today, Mr. Congressman, we have heard much concern over the potential revenue loss that may take place in the Netherlands Antilles if the 30-percent withholding tax is eliminated. While this concern and sympathy is commendable and praiseworthy, I would submit that it is totally unfounded. All the existing tax payments that are now made to the Netherlands Antilles will continue for years to come, phasing out gradually as the existing debt matures. The debt now in place that has been funded through the NV subsidiaries will continue because of either existing contractual commitments contained in the debt itself, or because the interest rate is so attractive compared to current interest rates that companies will not want to pay off the debt early. Accordingly, there will be a natural phasein that will take place.

As such, you do not need to do anything to take care of this so-called problem. It automatically takes care of itself.

In summary, we respectfully recommend that legislation be enacted to eliminate outright and immediately the withholding tax on interest payments to foreign portfolio investors to enable free access to cost competitive international capital markets.

Thank you.

[The prepared statement follows:]

STATEMENT OF JOHN B. SPRING, ON BEHALF OF THE FINANCIAL EXECUTIVES INSTITUTE

My name is John B. Spring. I am Executive Vice President of Finance and Administration for National Car Rental System, Inc., and a member of the Committee on Corporate Finance of the Financial Executives Institute. The Financial Executives Institute is the professional association of more than 12,000 senior financial and administrative officers of over 6,000 organizations, large and small, throughout the United States and Canada, and it is on their behalf that I appear before you today.

In your deliberations, you have considered different proposals for dealing with the withholding tax on interest payments that presently is imposed on foreign lenders. Our objective in appearing here today is to register our support for legislation that would eliminate the 30% withholding tax on interest payments to foreign investors, thereby avoiding the need to employ special purpose financing subsidiaries when accessing otherwise cost effective Eurobond financing.

The Eurobond market has provided a major source of funds for U.S. corporations, as evidenced by the significant annual issuance of debt securities through Netherlands Antilles finance subsidiaries over the past several years. Elimination of the 30% withholding tax would afford direct access by corporations to the Eurobond market and, as a result, would therefore allow the elimination of: (1) the need to utilize special purposes financing subsidiaries; (2) the costs of establishing and administering these subsidiaries; (3) the payment of taxes to the Netherlands Antilles; and (4) the potential uncertainty surrounding continued availability of capital from international markets due to periodic renegotiations of existing tax treaties.

We believe, as a practical matter, that borrowings are not made now in cases where withholding apply. Accordingly, there would be no revenue loss to the Treasury by elimination of the 30% withholding tax. In fact, there would be a substantial gain to the Treasury—estimated to be anywhere from $50 to $150 million a year—since there would no longer be a necessity for taking a foreign tax credit for taxes paid to the Netherlands Antilles. While there has been legislation proposed under Section 141 of H.R. 4170 to disallow this tax credit against domestic taxes, this would be an attack on the symptom rather than the problem, and would simply make a bad situation worse. U.S. corporations would rather pay taxes to the U.S. if they have to pay them to anyone, and they have no taste for paying income tax to the Netherlands Antilles. Corporate treasurers continue to be concerned that they have to resort to arcane financial structures such as N.V. subsidiaries in order to obtain adequate financing. It is not a small matter, because in the last six years, overseas financing as a percent of all bond financing by U.S. corporations has been at least 12% a year, and as much as 28%. On average, over 18% of corporate bond issues have been done through overseas markets during the last six years.

From a public policy standpoint, it is clear to us that existing constraints to overseas markets should be removed, and certainly new and further constraints should not be put in their place. Repeal should be immediate, and should not be hampered by a so-called "phase-in," as suggested in the Senate bill. This would simply delay the effect of the repeal for no good purpose. At best, it would prolong a cumbersome and artificial financing device. The more likely result, though, would be that it would effectively cutoff overseas financing altogether until the phase-in period had passed. Such legislation, which would have the practical effect of benefitting no one, would not be wise.

In summary, we respectfully recommend that legislation be enacted to eliminate outright and immediately the withholding tax on interest payments to foreign portfolio investors to enable free access to cost competitive international capital markets.

FINANCIAL EXECUTIVES INSTITUTE,
Morristown, NJ, April 18, 1984.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, DC.

DEAR MR. ROSTENKOWSKI: We have followed with great interest the pending legislative proposals for the elimination of the withholding tax on interest payments to foreign investors. The Committee on Corporate Finance of Financial Executives Institute [1] would like to register its support for legislation that would eliminate the 30% withholding tax on interest payments to foreign investors, thereby avoiding the need to employ special purpose financing subsidiaries when accessing otherwise cost effective Eurobond financing.

The Eurobond market has provided a major source of funds for U.S. corporations, as evidenced by the approximately $10 billion average annual issuance of debt securities through Netherlands Antilles finance subsidiaries over the past three years. Elimination of the 30% withholding tax would afford direct access by corporations to the Eurobond market and would therefore allow the elimination of: (1) the need to utilize special purpose financing subsidiaries; (2) the costs of establishing and administering these subsidiaries; (3) the payment of taxes to the Netherland Antilles; and (4) the potential uncertainty surrounding continued availability of capital from international markets due to periodic renegotiations of existing tax treaties. In this regard, we also understand that the existing 30% withholding tax raises very little revenue for the U.S. treasurey on corporate securities because, as a practival matter, borrowings are not made in cases where the withholding tax would apply.

In summary, we respectfully recommend that legislation be enacted to eliminate outright the withholding tax on interest payments to foreign portfolio investors to enable free access to cost competitive international capital markets. In this regard, such free access would continue to be limited under legislative proposals to phase in the reduction of withholding taxes.

Sincerely,

JOSEPH A. SCIARRINO,
Vice President and Technical Director.

Mr. PICKLE. Thank you, Mr. Spring, and thank you for additional comments on the phasing out aspect of it.

Now, Mr. Ragland, I believe you are next on the list.

STATEMENT OF ROBERT A. RAGLAND, DIRECTOR OF TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. RAGLAND. Thank you, Mr. Chairman. I will be very brief.

My name is Robert Ragland. I am director of taxation for the National Association of Manufacturers. With respect to the repeal of 30 percent withholdiong, the NAM supports the Gibbons-Conable approach which is embodied in H.R. 3025, rather than the 5-year phase out under the Senate version. There are three reasons for that: the need to expand the pool of private capital available for capital formation, the need to resolve the legitimacy of existing transactions through the Netherlands Antilles window, and the need to promote U.S. exports.

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[1] Financial Executives Institute is the professional association of more than 12,000 senior financial and administrative officers of over 6,000 organizations, large and small, throughout the United States and Canada.

If the remainder of my statement is included in the record, I think all of those points are sufficiently briefed out, and there is no need to take additional time on this occasion.

[The prepared statement follows:]

STATEMENT OF ROBERT A. RAGLAND, DIRECTOR OF TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS

The National Association of Manufacturers is a voluntary business association of over 13,000 corporations, large and small, located in every state. Members range in size from the very large to over 9,000 smaller manufacturing firms, each with an employee base of less than 500. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

BACKGROUND

The United States taxes the worldwide income of U.S. citizens, residents and corporations. Nonresident aliens and foreign corporations, however, generally are taxed on only their income which is from U.S. sources or which is effectively connected with a business conducted by them in the United States.

In situations which the U.S. source income received by a nonresident alien or foreign corporation is interest, dividends or other similar types of investment income, the United States imposes a flat 30 percent tax on the gross amount paid if such income or gain is not effectively connected with the conduct of a trade or business by the taxpayer within the United States. If the income or gain is effectively connected with a U.S. trade or business of the foreign investor, the income is not subject to the flat 30 percent withholding tax, but instead is included in the U.S. tax return which must be filed for the business and is taxed at the ordinary graduated rates.

There are a number of exemptions to the 30 percent withholding tax both statutory and by treaty. For example, the U.S. income tax treaty with the Netherlands (as extended to the Netherlands Antilles) generally exempts U.S. source interest paid to persons of the Netherlands Antilles from withholding tax on U.S. source interest paid to them.

In recent years this treaty exemption has become important to U.S. corporations wishing to borrow in capital markets outside the United States. By establishing a finance subsidiary in the Netherlands Antilles, and paying interest on foreign demonstrated notes to that subsidiary, the U.S. borrower is by treaty absolved from the duty to withhold tax at the 30 percent rate. As the Netherlands Antilles imposes no tax on the subsequent transfer by the subsidiary to the foreign borrower, this income from the foreign investor passes intact thus insuring the full benefit to the lender. In the absence of these treaty provisions, U.S. borrowers would be compelled to withhold at the 30 percent rate and make up the difference in the form of a higher rate of return. In most debt instruments, the U.S. parent and the finance subsidiary agree to idemnify the foreign bondholder against all U.S. withholding taxes (including interest and penalties). Also, if the IRS successfully challenges the claimed exemption, or if the U.S. tax law or treaty provisions change, then the bonds are callable immediately.

THE PROVISION

The Senate version of the deficit "down payment" plan, H.R. 2163, provides for the phased-out repeal of the 30 percent withholding tax on certain interest payments to nonresident alien individuals on portfolio debt investment. The bill reduces the rate of tax on such interest payments from 30 percent to 5 percent on the date of enactment, and thereafter by 1 percentage point per year until 1988 at which time the rate would be zero. The phase out applies to interest paid on three categories of portfolio debt investments where the interest is paid to a nonresident alien individual or a foreign corporation. These are:

1. Bearer Notes
2. Interest on Registered Obligations
3. Assumed Debt

In all three cases the bill provides safeguards to ensure that the interest benefit inures only to nonresident aliens and foreign corporations neither of which are effectively connected with the active conduct of a trade or business within the United States.

The House version of the deficit down payment plan, H.R. 4170, contains no similar provision.

POSITION

The National Association of Manufacturers supports the objective of this provision: that U.S. corporations be provided with access to foreign capital markets, and that foreign investors be made secure in the expectation that the full benefit of their investment in the United States will be realized. We would prefer, however, that these incentives to capital formation occur upon the date of enactment rather than over five years.

NAM support for the repeal of the 30 percent withholding is based on:

1. The need to expand the pool of private capital available for capital formation.
2. The need to resolve the legitimacy of existing transactions.
3. The need to promote U.S. exports.

Presently, federal borrowing demands consume all but 1.8 percent of private savings available for investment. The resulting competition between corporations, the public, and the government causes interest rates to rise through the so called "crowding out" effect.

Foreign capital markets relieve the crowding out effect by expanding the pool of savings available for capital and plant expansion. Given that federal deficits will continue to result in unusually heavy demands on domestic capital markets for the foreseeable future, the United States must ensure flexible access to foreign capital markets or risk higher interest rates here.

More than ensuring existing access to foreign capital markets, federal policy with respect to existing foreign indebtedness should be made clear. Because of a finance subsidiary's limited activities, the lack of any significant earning power other than in connection with the parent guarantee and the notes of the parent, and the absence of any substantial business purpose other than the avoidance of U.S. withholding tax, offerings by finance subsidiaries involve difficult U.S. tax issues in the absence of favorable IRS tax rulings. Since the marketing of a bond offering is based upon the reputation and earning power of the parent, and since the foreign investor is ultimately looking to the U.S. parent for payment of principal and interest, there is a risk that the bonds might be treated as, in substance, debt of the parent, rather than the subsidiary, and thus withholding could be required.

The NAM believes that finance subsidiary arrangements satisfy in form the requirements for an exemption from the withholding tax. Notwithstanding this, recent challenges by IRS field agents are having a chilling effect on foreign investment in the United States. When we remove this cloud, an even broader resource pool will be available to U.S. borrowers thus relieving somewhat the crowding out effect and thereby moderating U.S. interest rates.

U.S. interest rates have dropped dramatically from historical highs just three years ago. In real terms, however, they still are substantial enough to attract foreign investors. While the strength of the U.S. dollar in world markets encourages the flow of capital into the United States, it also is making the price of U.S. manufactured goods in foreign markets prohibitively high. Coupled with aggressive competition, this has led to a trade deficit estimated in 1984 to reach $100 billion. The Council of Economic Advisers suggests that 50 percent of this deficit is directly attributable to deficits spending which drives up the value of the dollar.

NAM has argued for some time now that a greatly expanded pool of private savings is an absolute prerequisite to capital expansion in this country. We see the repeal of the 30 percent withholding tax as an important part of that program.

CONCLUSION

The NAM supports the immediate repeal of the 30 percent withholding tax on foreign portfolio investment in the United States. In the upcoming Senate-House conference on the deficit down payment plan we will be urging the conferees to adopt the Senate version without the five year phase in provision.

Mr. PICKLE. I thank you. That is very good testimony.

Now, Mr. Hannes.

STATEMENT OF STEVEN P. HANNES, CHAIRMAN, INTERNATIONAL TAX SPECIALTY GROUP, TOUCHE ROSS & CO.

Mr. HANNES. Thank you. My name is Steven Hannes, and I am the chairman of the International Tax Specialty Group of Touche Ross & Co., an international tax consulting and public accounting firm.

I appreciate this opportunity, however brief, to put before you our views on proposed legislation to allow direct access to the Eurodollar market. We strongly endorse such legislation. We believe it represents good tax policy, it would simplify existing operations which today are, shall we say, tax driven, and would eliminate the need to pay a foreign tax to obtain access to the Eurodollar market.

We believe the legislation is helpful in that it makes the savings of the Eurodollar market available to a larger class of persons such as small issuers and, hopefully, the U.S. Government.

Also, the legislation is a positive step because it would eliminate rather contentious issues now in place between the IRS and taxpayers. These issues would go away for the future.

I would like to make a comment about the concern with respect to compliance. There is an important aspect of this legislation which may have a positive effect on compliance with respect to U.S. taxpayers. That is the legislation would only authorize the exemption from withholding tax with respect to payments to countries that give the U.S. Government appropriate access to tax information. In this sense, the proposed legislation may actually decrease tax evasion by U.S. taxpayers.

Also, solving the Eurodollar access issue legislatively removes an important and difficult issue from the tax treaty process. Hopefully, removing this issue from the tax treaty process will facilitate a settlement of the United States-Antilles dispute in a way which will recognize both the economic reliance of the Antilles on the tax treaty and the United States desire to achieve direct tax treaty relationships with many countries, and incidentally, improve tax treaty relationships with existing treaty countries.

If this occurs, U.S. taxpayers stand to benefit by reductions in foreign taxes achieved through new and improved tax treaties.

Since our time seems to be up, I will go to my conclusion. In brief, we believe that the legislation is an appropriate solution to a vexing problem, one which has existed for many years. Every administration since 1970 has hoped for legislation such as this. We strongly support its enactment.

Thank you.

[The prepared statement follows:]

STATEMENT OF STEVEN P. HANNES, CHAIRMAN, INTERNATIONAL TAX SPECIALTY GROUP, TOUCHE ROSS & CO.

Mr. Chairman and members of this distinguished Committee, my name is Steven P. Hannes and I am the Chairman of the International Tax Specialty Group of the international tax consulting and public accounting firm of Touche Ross & Co. I appreciate the opportunity today to put before you the views of Touche Ross supporting legislation such as H.R. 4029 and H.R. 3025 which would amend the Internal

Revenue Code of 1954 (the Code) to exempt from U.S. income tax interest paid to certain nonresidents on various types of debt instruments, frequently called Eurodollar or Eurobond offerings. Legislation such as that contained in these bills is extremely important to the U.S. tax system and should be enacted as expeditiously as possible.

The tax exemption provided by the bills to certain nonresident aliens and foreign corportations would generally create the following benefits:

(1) It would offer U.S. borrowers a practical means of attracting certain types of foreign investment;

(2) It would remove the current incentive to use so-called "offshore finance subsidiaries" to borrow overseas, thereby eliminating future disputes between the I.R.S., U.S. taxpayers and treaty partners; and,

(3) It would offer an opportunity to restore the ability of the U.S. Government to determine whether and to what extent residents of various foreign countries will receive certain U.S. income tax benefits, thereby assisting the expansion and improvement of the U.S. income tax treaty program, and possibly saving foreign taxes for U.S. persons.

The Eurodollar market has frequently proven to be an attractive and important source of capital for the United States. Even the U.S. Government has been attracted to this market. For example, the Federal National Mortgage Association has explored with Treasury the possibility of Eurodollar financing as a source of funds for housing. While estimates vary greatly on the amount of capital that the Eurodollar market has contributed to U.S. companies and the U.S. economy—primarily through debt currently issued by offshore finance subsidiaries—by any standard the amount appears significant. Particularly in a period of U.S. economic recovery, it is very appealing to have this large and expanding market readily available to the United States as a source for capital.

The importance of assuring tax-free access to the Eurodollar or Eurobond market has not been lost on other countries. For example, the U.K. will probably enact in 1984 legislation which would assure that United Kingdom entities could obtain certain types of offshore financing without suffering the cost of the U.K. 30 percent withholding tax on interest. Other countries, such as the Netherlands, guarantee tax-free access by way of a broad exemption for interest paid to nonresidents. Thus, legislation such as H.R. 3025 and H.R. 4029 would generally conform the U.S. tax treatment of interest on Eurodollar bonds to the tax treatment provided similar interest by certain other developed countries.

The paragraphs that follow elaborate on our basic observations on this proposed legislation.

In a practical sense, U.S. companies find the Eurodollar market attractive, not only because it presents an additional source of capital but also because the cost of borrowing that capital is frequently lower than it would be in the United States. That is, interest rates on Eurodollar offerings are frequently lower than on U.S. financing. This cost saving would, however, usually be nullified if a U.S. company issued debt directly to a foreign person. That is, in the usual situation, Section 871(a) or 881(a) of the Code would impose a 30 percent Federal income tax on the gross amount of the interest paid by a U.S. company to a foreign lender. In the case of Eurodollar offerings, this income tax burden would probably be borne economically by the U.S. borrower because lenders customarily insist that interest paid on the Eurobond issue be "grossed-up" to include any such withholding tax. The resulting interest rate would be uneconomically high; this has led to the use of borrowing arrangements designed to avoid withholding taxes.

For some years, U.S. companies have legally avoided the 30 percent U.S. tax on Eurodollar interest by using the following arrangements:

(1) A U.S. company would invest the borrowed funds outside of the United States under arrangements designed to prevent the interest it pays from being U.S.-source; or

(2) A foreign affiliate—offshore financing subsidiary—would borrow in the Eurodollar market and relend to its U.S. affiliates.

The second type of financing, as described below, has been faciliated by U.S. income tax treaties. In both types of financing arrangements the U.S. parent company typically assures the commercial viability of the debt offering by guaranteeing the debt of its subsidiary.

The proposed legislation is intended, in general, to allow U.S. companies (and, subject to our comments below, the U.S. Government) to acvhieve the U.S. tax savings currently allowed in the foreign affiliate arrangement, but would eliminate the need for an offshore finance subsidiary. Thus, U.S. companies could reach the Eurodollar market directly and obtain the same (or perhaps greater) economic savings enjoyed now. In this sense, the proposed legislation would appropriately simplify the existing Eurodollar financing mechanism. Additionally, the proposed legislation would, hopefully, allow the U.S. government to enjoy these same savings.

One advantage of this simplification is that it should eliminate, for the future, contentious U.S. tax issues currently facing those corporations which have employed offshore financing vehicles to reach the Eurodollar market. These issues involve whether the offshore finance subsidiary or its U.S. parent is the true "obligor" of the Eurodollar offering, or whether the interest expense shown on the books and records of the offshore finance subsidiary is more properly viewed, for U.S. income tax purposes, as interest paid directly to the foreign lender by the U.S. parent company. Under current law, if the debt is considered that of the U.S. parent rather than of its foreign affiliate, or if the interest is considered paid to the foreign lender by the U.S. parent rather than by its foreign subsidiary, there would normally be a 30 percent U.S. tax imposed on that interest under Code Section 871(a) or 881. Legislation such as that being discussed today can eliminate these disputes for the future by rendering unnecessary the use of financing arrangements which generate them.

As mentioned above, income tax treaties play a role in current arrangements involving offshore finance subsidiaries. The Income Tax Convention between the United States and the Netherlands, as extended to the Netherlands Antilles (Netherlands Antilles Convention), has been used frequently for Eurodollar offerings. It has two provisions which, taken together, make it particularly attractive. The first is an exemption from United States withholding tax on interest paid to an Antilles corporation which is not engaged in a trade or business through a U.S. permanent establishment. Thus, if creation of a permanent establishment can be avoided, there is usually no U.S. tax on interest paid to the Antilles entity. (If for some reason the Antilles entity is found to have a U.S. permanent establishment, then its business profits are subject to U.S. tax on a net basis, subtracting the interest paid to foreign investors from the interest received from the U.S. affiliate. The resulting net income is very small.)

The second advantage of the Netherlands Antilles Convention is the assurance that the offshore finance subsidiary can pay interest to its lenders free of the 30 percent U.S. withholding tax, even if the subsidiary is considered to be earning income effectively connected with the conduct of a trade or business in the United States. Absent a treaty, the Code treats interest paid by a foreign corporation which is engaged in trade or business in the United States as being from U.S. sources, if 50 percent or more of the gross income of the company is effectively connected with the conduct of the trade or business in the United States. If that happens, some or all of the interest paid by the company would be subject to the 30 percent U.S. tax. Under the Netherlands Antilles Convention, however, the 30 percent withholding tax is not imposed on interest paid by the Antilles company whether or not its U.S. operations constitute a trade or business. Importantly, the exemption in the Convention applies regardless of where the recipient of the interest resides. Thus, a resident of any country can legally avoid the 30 percent U.S. tax that might otherwise apply on Eurodollar interest by way of the Netherlands Antilles Convention.

This and other types of so-called "third country use" of U.S. tax treaties may have been accepted with few questions 20 years ago, but have been increasingly challenged as a matter of U.S. tax policy in recent years. See, for example, the Hearings before the House Governmental Operations Subcommittee on Commerce, Consumer and Monetary Affairs, on April 13, 1983, where this matter was considered in the context of the Netherlands Antilles Convention. It appears that, so long as the Netherlands Antilles remains the principal avenue for U.S. companies to reach the Eurodollar market, it may be very difficult for the U.S. Government to negotiate a new treaty with the Netherlands Antilles that would, from the perspective of the U.S. Government, appropriately limit the opportunities for residents of third countries to take advantage of U.S. tax savings through the Netherlands Antilles.

If legislation such as that being discussed here today were enacted, U.S. companies would have an alternative route to the Eurodollar market. This would provide a better opportunity to rationalize the current Netherlands Antilles Convention. Such a rationalization would have important implications to the U.S. tax treaty program. Among other things, it could lead to an expansion of the number of countries interested in achieving a tax treaty relationship with the United States and a concomitant reduction in foreign taxes currently paid by U.S. persons to such countries. In addition, countries which currently have U.S. tax treaties but which have had less of an incentive to improve these treaties (because their residents could save U.S. tax by investing in the United States through the Netherlands Antilles), may now find it attractive to improve their U.S. income tax treaty. Such an improvement may reduce the taxes these countries now collect from U.S. persons. In brief, the proposed legislation could restore, to a considerable extent, the ability of the U.S. Government to determine whether and to what residents of various countries will receive certain U.S. tax benefits. Thus, in a number of respects, the proposed legislation has important, and favorable, international tax policy implications.

The principal difference between H.R. 4029 and H.R. 3025 is that the latter would allow exemption from the 30 percent withholding tax for interest paid on any registered obligation for which a statement of foreign ownership has been received. H.R. 4029 would not allow an exemption for such an obligation. We are interested in hearing today the arguments for and against excluding a registered obligation from the scope of this proposed exemption. We believe it is very important that any legislation intending to allow direct access to the Eurodollar market actually achieve that purpose. In other words, if H.R. 4029 would, as a legal or practical matter, preclude the intended beneficiaries of this legislation (e.g., a U.S. government agency) from having direct access to the Eurodollar market, then H.R. 3025 would appear to be, of the two bills being considered today, the preferable bill. We are particularly concerned about the effectiveness of H.R. 4029, in this regard, because we have been advised that H.R. 4029 is not intended to cover any government securities, and that this exclusion may be "clarified" or achieved by way of language in the committee report or a technical amendment. Given the language of the current version of H.R. 4029 we are doubtful that such a "clarification" would, as a matter of statutory construction, be effective. In any case, it is important that legislation approved by the Committee allow the U.S. Government to have direct access to the Eurodollar market.

We would like to make one brief comment on proposed Section 898, which is in both bills and would deny the interest exclusion to residents of any foreign country, if the Secretary determines that information exchanged with that country is inadequate to prevent tax evasion. The objective of the section is reasonable—to act as an incentive for foreign countries to provide necessary information and, if necessary, to negotiate agreements to do so—but as presently worded it may present problems. Most foreign countries have laws protecting the secrecy of tax information, similar in effect to our own. In other words, most countries can only give out tax information by way of an executive agreement, tax treaty, or mutual assistance treaty. One could view any country which does not have such an agreement or treaty with the United States on the date of enactment of the proposed legislation having an "inadequate exchange." Thus, under this interpretation, the section would have immediate consequences when the amendments in the bill take effect, without any provision for a period within which negotiations could take place. Moreover, the section is both mandatory in application once a determination is made and applicable to all interest paid on post-determination obligations to the country which is the subject of the determination. This may be a penalty so great that it never will be invoked. We recommend, therefore, that the Committee take steps, perhaps by way of comments in the Committee Report, to make clear that the Secretary has discretion in the application and in the scope of the section. This would assure the fairness of the section as well as give the section the maximum utility in tax administration.

In conclusion, we endorse the broad objectives of the proposed legislation and encourage the Committee to move as expeditiously as possible to assure that Eurodollar offerings can be issued without the use of an offshore finance subsidiary and free of the 30 percent withholding tax. Such legislation would simplify current arrangements, avoid contentious issues on audit, and potentially restore a measure of U.S. control over certain U.S. tax benefits, thereby assisting in the expansion and rationalization of the U.S. income tax treaty network and possibly providing foreign tax savings to U.S. investors overseas.

Mr. PICKLE. You are testifying in favor of H.R. 3025, the Gibbons-Conable bill?

Mr. HANNES. Sir, we are testifying in favor of legislation which would provide a pragmatic solution to the Eurodollar problem. It seems to me that there are some good arguments in favor of the broader legislation and some difficult questions with respect to the narrower bill.

One thing that must be kept in mind, it seems to me, is that in enacting legislation, it should provide an appropriate substitute to the tax treaty process. If the legislation from Mr. Barnard were written in such a way that U.S. Government obligations would not have direct access, then that would be most troublesome. Comparing the two bills on that basis, we would prefer the broader version.

Mr. **Thomas**. You said you endorsed the broad objectives of the proposal, is that correct?

Mr. **Hannes**. That is correct.

Mr. **Pickle**. Well, I thank you very much, and I appreciate your statement, and I appreciate your cooperation.

We do not like to schedule these hearings and panels and then find ourselves at the end of the day with insufficient time, but sometimes we cannot help that situation. This is one of those instances.

So we thank you, and your entire statement will be included in the record. We appreciate your cooperation.

There being no other witnesses to testify, the committee will stand adjourned.

[Whereupon, at 3:52 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

AIR TRANSPORT ASSOCIATION OF AMERICA,
Washington, DC, April 24, 1984.

Mr. JOHN SALMON,
Chief Counsel, Ways and Means Committee, Longworth House Office Building, Washington, DC.

DEAR MR. SALMON: According to committee press release no. 20, dated April 5, hearings will be held on May 1 concerning legislation addressing tax treatment of interest paid to foreign persons. It would be appreciated if the text of this letter was included in the hearing record.

The Air Transport Association of America (ATA) is a trade association which represents most of the U.S. scheduled airlines. ATA appreciates the opportunity to express its views on the legislative proposals, which, if enacted, would alter or repeal the 30 percent withholding tax on interest paid to foreign investors.

Among the proposals, H.R. 3025 generally would repeal the 30 percent withholding tax on interest paid to foreign investors on portfolio indebtedness. H.R. 4029, on the other hand, would repeal the tax on interest payments from debt issued by certain private parties only (e.g., Eurobond offerings).

Historically, airlines required large sums of capital to modernize or replace their aircraft fleets. The need to replace aging aircraft with the new and high technology aircraft continues today.

The 30 percent withholding tax on interest paid to foreign investors has limited the amount of foreign funds available to the airlines and has increased the cost of those funds. Repeal of this withholding provision would allow more direct access to foreign funds at a lower cost.

Accordingly, the airlines urge that the 30 percent withholding tax be repealed in whole or in part. The airlines would support the complete repeal of the withholding requirements

Sincerely,

WILLIAM J. BURHOP,
Senior Vice President, Government Affairs.

AMERICAN BANKERS ASSOCIATION,
Washington, DC, May 1, 1984.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, DC.

DEAR MR. SALMON: The American Bankers Association supports legislation to repeal the 30 percent withholding on certain interest payments to non-resident aliens and foreign corporations. The bill, H.R. 3025, will assist U.S. borrowers by allowing them to use a simple and direct method to attract funds from foreign investors.

THE EUROBOND MARKETS

The impact of H.R. 3025 can be understood by recognizing the importance of the Eurobond market as a source of funds for U.S. corporate borrowers, including banks.

No large borrower of funds in the world today can ignore the Eurobond market because it is a sizeable source of capital and is growing more rapidly than the U.S. corporate bond market. The growing importance of the Eurobond market as a source of capital for U.S. companies can be amply demonstrated by the extent to which U.S. businesses have increased their borrowing in the Eurobond markets in recent years. The percentage of U.S. corporate public debt financing in the overseas capital market increased in 1982 to 28 percent of public debt financing by U.S corporations, up from 10 percent in 1980. During that time, the total dollar value of U.S. corporate Eurodebt issues increased from $4.4 billion to $14.5 billion.

Not only is the overseas capital market large, but its investors have somewhat different investment objectives in investing in securities than do U.S. domestic bond investors. Generally, Eurobond buyers look for bearer bonds, annual coupons, front-end discounts, maturities bunched in the five to seven year ranges, tighter call provisions, better credits; they are historically more interested in floating rate notes and warrants than U.S. investors. In addition, Eurobond buyers often are motivated by a desire to hedge exchange risks between US dollars and their indigenous currencies. Borrowing in foreign capital markets thus enables banks to diversify their sources of funds to obtain the liquidity, pricing, and other terms necessary to enable them to function profitably as lenders.

Under H.R. 3025, these same benefits of diversification, liquidity and pricing would be available to the U.S. government. Just as U.S. corporations have increasingly turned to foreign investors for the capital necessary to finance growth, so too, the Federal government has sought to attract foreign investment in government securities to spur economic recovery. Repealing the withholding tax on non-resident aliens would remove a serious impediment currently dissuading many foreigners from investing in U.S. government offerings. Adoption of H.R. 3025 would give the government greater access to a broader spectrum of investors, and, as a result, should have the effect of facilitating financing of the federal deficit.

ACCESS TO FOREIGN CAPITAL

The foreign capital markets are not directly available to U.S. corporations (and the U.S. Government) because of the 30 percent withholding tax under Internal Revenue Code section 871 and 881, which is applied to interest payments to foreign investors. In this sense, the withholding tax generally does not act as a tax which raises revenue but rather as a tariff which restricts foreign investment activity to a large degree. As a result, U.S. corporate borrowers generally must obtain indirect access to foreign markets through establishing Netherlands Antilles finance subsidiaries. This method of borrowing avoids the imposition of the U.S. withholding tax on foreign investors due to the treaty between the U.S. and the Netherlands, as extended to the Antilles. The subsidiary borrows funds from foreign lenders and relends those funds, subject to the tax imposed by the Antilles, to the parent company in the U.S.

If repeal of the 30 percent withholding tax is enacted, it will eliminate the need for U.S. corporations to use an indirect off-shore finance company route to obtain access to the Eurobond market. The result will be that more U.S. corporations will be able to tap foreign capital through the direct issuance of their debt obligations. This will open new opportunities in the availability of raising capital in foreign markets. It would enable medium size and small businesses to raise funds from foreign sources for the first time, without the cost and complexity of setting up a Netherlands Antilles finance subsidiary.

NEED FOR CERTAINTY

The existence of U.S.-Netherlands Antilles Tax Treaty presently provides a means for U.S. companies to obtain access to foreign capital markets. However, there is considerable uncertainty about the continuation of this tax treaty. The U.S. has been in the process of renegotiating its tax treaty with the Netherlands Antilles for approximately 3 years. It is uncertain whether any new treaty may include which would continue to affirm the opportunity for U.S. corporations to have access to the Eurobond market through the Netherlands Antilles finance subsidiaries. Until recently, the Internal Revenue Service had approved the use of Netherland Antilles subsidiaries; however, the IRS has recently raised tax audit issues with regard to these transactions. If it is determined that they are no longer exempted from the withholding tax, existing obligations of those companies would be adversely affected. An unfavorable IRS ruling could force U.S. corporations to cancel any future bond issues through the Netherlands Antilles subsidiaries with potentially dramatic consequences on domestic interest rates.

COMPLIANCE

ABA suggests that the bill be amended to include an appropriate modification to Internal Revenue Code Section 6049, to provide an exemption from the information reporting requirements (including Taxpayer Identification Number (W-9) and Nonresident Alien (W-8) certifications) for debt issues which comply with certain standards to ensure both that the instruments are not sold to U.S. persons. Changes to the information reporting requirements are necessary for euro-debt instruments to be saleable. Standards involving legends on the face of the instruments and procedures governing their sale similar to those applicable to the exception in subsection (f) to the registration requirements of Section 163 of the Internal Revenue Code would be appropriate.

CONCLUSION

Elimination of the 30 percent withholding tax will have the effect of reintegrating the two separate bonds markets which now exist, U.S. and Eurobond. This expanded market access could result in an easing of pressures on domestic interest rates. If this legislation is not adopted, a suitable alternative means of continued access to the Eurobond market must be found. If such access were not available, overseas capital markets would be closed to future offering by U.S. corporations. Shutting off the Euro-market would have a dramatic impact on U.S. borrowers because of the current size and importance of that market. This would result in putting severe pressure on domestic capital markets, and would generally force refinancing of existing issues. Complete, open and unfettered access to the Euro-market is necessary to ensure continued economic growth.

Thank you for this opportunity to comment on the provisions of H.R. 3025.

Sincerely,

GERALD M. LOWRIE,
Executive Director, Government Relations.

STATEMENT OF THE AMERICAN FEDERATION OF LABOR & CONGRESS OF INDUSTRIAL ORGANIZATIONS

The AFL-CIO is in opposition to both H.R. 3025 and H.R. 4029, proposals which would eliminate the 30 percent withholding tax on certain interest paid to nonresident aliens and foreign corporations on U.S. source income. We opposed similar measures in 1980 and in 1975—as did a Congressional majority. Today's economic conditions demand that this latest attempt at repeal be similarly rejected.

Present law provides, in general, that interest, dividends, and other similar types of income of a nonresident alien or a foreign corporation are subject to a 30 percent tax on gross amount paid, if such income or gains are not effectively connected with the conduct of a trade or business within the United States. This tax is generally collected through withholding by the entity making the interest or dividend payment to the foreign recipient of the income. For this reason, the tax is commonly referred to as a withholding tax.

We note that in 1982, the most recent year for which data is available, $152.5 million of tax was withheld on interest paid to foreign investors. The direct revenue effect of H.R. 3025 with some exceptions would be the loss of all withholding tax receipts. The loss in withholding tax under H.R. 4029 would likely be smaller since it reduces the statutory withholding rate to zero only on special bearer bond issues designed for the foreign market.

Those advocating the repeal of the interest income portion of these provisions justify their position as a means to attract foreign capital, with a resultant benefit to the U.S. economy and the generation of jobs. In our view there is absolutely no reason to accept as blanket assumption that foreign investment in the United States creates jobs for Americans or is necessarily beneficial to the American economy. In fact, the type of investments that would be encouraged through eliminating the 30 percent withholding tax would, in the main, be speculative "hot" money that can and does move quickly and freely from country to country. Speculative capital that comes in to the U.S. temporarily as a result of tax preferences is not the kind of capital that creates jobs, increases productivity or contributes to the health of the economy. To the contrary, such flows merely add to instability and uncertainty.

In addition, most industrialized foreign countries allow their citizens to offset, through credits or other means, taxes paid to other countries against those levied in their home country. Thus, in these circumstances repealing the U.S. tax merely amounts to a transfer of funds from the U.S. Treasury to the treasury of a foreign government.

Repealing the present 30 percent withholding tax on interest income would add a new tax preference. We see no reason why foreign investors who enjoy the security, protection and profit from investing in the United States should be exempted from making some contribution to this nation's taxes. American investors are required to pay income taxes on their interest income to the U.S. government when earned in the U.S. and, except where waived by bilateral treaties, they also pay taxes to foreign governments on income earned overseas. It is impossible to reconcile a policy of high interest rates on U.S. citizens struggling to purchase a home or an automobile when at the same time, we encourage Wall Street to float U.S. corporate bonds in foreign markets using a tax break not available to American citizens. We note, for example, that in the past this nation's large brokerage houses helped lead the attempt to repeal this provision.

As Americans we have long criticized those so-called "tax-haven countries" which, in an effort to lure capital, grant special tax exemptions. The AFL-CIO does not feel that the United States should follow the example set by these countries. In fact, in 1975 as part of the Tax Reduction Act the Congress eliminated some of the tax avoidance opportunities enjoyed by U.S. multinational companies that operate in the "tax haven countries."

The AFL-CIO urges the rejection of both H.R. 3025 and H.R. 4029, proposals which would eliminate the 30 percent withholding tax on certain U.S. source income paid to foreign investors.

STATEMENT OF FREDERICK HOWARD, COALITION OF SERVICE INDUSTRIES, INC.

The Coalition of Service Industries (CSI) consists of 29 major U.S. service corporations which represent a wide cross-section of the U.S.-owned international operating service industries, including high-tech, banking, insurance, engineering, financial consulting, and telecommunications.

The CSI was formed in 1982 to: (1) foster a public awareness and understanding of the enormous contribution that these industries make to U.S. economic growth, job creation, and balance of payments; (2) identify and address public policy issues affecting the growth of service industries; and (3) contribute to the formulation of a coherent national policy that permits service industries to compete with foreigners on an equal basis in the international services market.

Private sector service industries are labor-intensive. They provide jobs for 55 million Americans, over half of the American work force. These industries generated 55 percent of the 1981 gross national product (GNP), over 60 percent of the total private sector GNP, and have made the U.S. the world's leading exporter of services. Surpluses from the export of services and the remittance of foreign earned profits have consistently reduced merchandise deficits in our balance of payments.

The CSI is approaching the subject of these hearings more as a potential acquirer of the portfolio securities than as an issuer. We are in support of any proposal which the Committee feels will, as matter of sound tax policy, permit U.S. issuers direct access to the Eurodollar market.

Many of our members, through their U.S.-controlled foreign subsidiaries, currently invest their working capital in Eurobonds issued by international finance subsidiaries. These bonds carry the guarantee of U.S. or foreign-owned corporations or the guarantee of foreign governments. To date, these bonds have not been subject to U.S. or foreign withholding taxes.

We are concerned with a provision in the various bills (Conable/Gibbons/Barnard and Chafee/Bentsen) which would impose the 30 percent U.S. withholding tax if the acquirer of future U.S. issues were a U.S.-owned and controlled foreign corporation. This provision makes no sense as a matter of tax, economic, or other policy. The new law would effectively prevent U.S.-owned foreign subsidiaries from investing in U.S. portfolio securities and encourage them to buy foreign government and corporate bonds, the interest upon which is exempt from taxation. This policy is contrary to U.S. Balance of Payments objectives, imposes an unnecessary market limitation on U.S.-oriented foreign investors, and will not raise revenue or serve other tax policy objectives.

The exclusion of U.S.-controlled foreign corporations from the U.S. withholding tax-exempt bills (Conable/Gibbons/Barnard and Chafee/Bentsen) was originally based on the Treasury Department's concern that U.S. source interest paid to controlled foreign corporations would be resourced as foreign source income for foreign tax credit purposes when distributed to the controlled foreign corporation's shareholders. However, that possibility of abuse will effectively be eliminated by the enactment of Section 141 of the House bill and Section 128 of the Senate bill, both of which treat U.S. source interest income of a controlled foreign corporation as U.S. source income to its U.S. shareholders.

Also, to prevent U.S.-controlled foreign corporations from investing in U.S.-issued debt obligations, is inconsistent with the policy that led Congress in 1976 to narrow the definition of an "investment in United States property" so that an investment by a U.S.-controlled foreign corporation in a debt obligation of an unrelated U.S. person would not be treated as a constructive dividend under Section 956 of the Internal Revenue Code. In explaining that change, the House Ways and Means Committee stated [H. Report 94-658, 94th Congress, First Session, p. 216 (1976)]:

> "Your Committee believes that the present scope of the [investment in United States property] provision is too broad. In its present form it may, in fact, have a detrimental effect upon our balance of payments by encouraging foreign corporations to invest their profits abroad. For example, a foreign corporation looking for a temporary investment for its working capital is, by this provision, induced to purchase foreign rather than U.S. obligations. In your Committee's view a provision which acts to encourage, rather than prevent, the accumulation of funds offshore should be altered to minimize any harmful balance of payments impact while not permitting the U.S. shareholder to use the earnings of controlled foreign corporations without payment of tax.
>
> In your Committee's view, since the investment by foreign corporations in the stock or debt obligations of a related U.S. person or its domestic affiliates make funds available for use by the U.S. shareholders, it constitutes an effective repatriation of earnings which should be taxed. The classification of other types of investments as the equivalent of dividends is, in your Committee's view, detrimental to the promotion of investments in the United States. Accordingly, your Committee's bill provides that an investment in U.S. property results only if the foreign corporation invests in the stock or obligations of a related U.S. person or in tangible property which is leased to, or used by a related U.S. person."

A similar statement was made by the Senate Finance Committee [S. Report 94-938, 94th Congress, Second Session, p. 264 (1976)].

The balance of payments and tax policies expressed by the Committee in 1976 should be the same for the excise tax provisions now being considered before this Committee.

STATEMENT OF JOHN B. JONES, JR. AND WILLIAM E. O'BRIAN, JR., COVINGTON & BURLING, WASHINGTON, DC

The Gibbons-Conable Bill, H.R. 3025, the Barnard Bill, H.R. 4029, and the Deficit Reduction Act of 1984, as passed by the Senate on April 13, 1984 as an amendment to H.R. 2163, provide for the repeal of the 30 percent withholding tax on interest paid by domestic corporations to foreign lenders. Under current law, some corporations achieve similar results by borrowing through international finance subsidiaries, many of which are incorporated in the Netherlands Antilles. All three bills provide that the benefits of the newly reduced, or eliminated withholding are available for certain debt assumed by domestic corporations after the effective date of the Act. The purpose of these provisions is to allow companies which previously obtained reduced or zero withholding indirectly to do so directly under the new law.

If the tax were to be repealed, these bills correctly allow many domestic affiliates of finance subsidiaries to assume the debt of these subsidiaries and to obtain the same reduced withholding rate. However, there is a technical deficiency that was no doubt unintended but that could have serious consequences for some domestic corporations. This arises from the restriction that allows assumption of debt only where that debt was guaranteed by a domestic corporation.

Much of the debt issued by international finance subsidiaries is guaranteed by domestic corporations. There are international finance subsidiaries, however, that have substantial economic viability and substance in their own right. At least one such subsidiary, GTE Finance N.V., has outstanding substantial Eurodollar debt not guaranteed by its parent or any domestic affiliate.

As of January, 1984, GTE Finance N.V. had approximately $1.3 billion of assets, including obligations of more than 40 unaffiliated debtors. Established in 1978, the company has its own employees (currently eleven) and offices in Curaçao. Less than 10 percent of GTE Finance N.V.'s debt is guaranteed by domestic corporations (or indeed by any corporation). No guaranteed debt has been issued since 1980. It has established itself as a free-standing company in world financial markets with continuing responsibilities to debtors and creditors and has established a very significant presence and base of activities in the Netherlands Antilles.

No discernible public policy would be served by giving debt issued by less active corporations more favorable treatment than debt issued by GTE Finance N.V. Certainly GTE Finance N.V. should not be punished for having established its own independent economic viability and substance. The requirement that debts, to be assumable without a 30 percent withholding tax, have been guaranteed by a domestic corporation would have just that effect. If it is necessary to limit the debt that can be assumed under this provision, a sufficient limitation would be to restrict such assumptions to debt issued by a corporation that is a member of the same controlled group of corporations (within the meaning of Section 1563(a) of the Code) as the corporation assuming the debt.

Accordingly, we suggest that the Senate bill be amended by substituting for Code Section 871(h)(3)(C), as added by Section 142 of the bill, the following:

> "(C) CERTAIN ASSUMED OBLIGATIONS.—Interest which is paid on an obligation which resulted from the assumption after the date of enactment of this subsection by a domestic corporation of an obligation—
>
> (i) which was issued on or before such date by a corporation that is a member of the same controlled group of corporations (within the meaning of section 1563(a)) as the domestic corporation assuming such obligation;
>
> (ii) which was issued pursuant to arrangements described in Section 163(f)(2)(B)(i); and
>
> (iii) with respect to which the domestic corporation meets, under regulations prescribed by the Secretary, reporting and similar requirements of this title which would be imposed on the person from whom such obligation was assumed."

Comparable changes could be made in the Gibbons-Conable or Barnard bills.

ALCALDE, HENDERSON & O'BANNON,
Rosslyn, VA, April 30, 1984.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
U.S. House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: Attached please find the prepared statement of our client, the European Federation for Retirement Provision, which is respectfully submitted to be a part of the record of your May 1 hearings on H.R. 3025, a bill to repeal the withholding of interest due non-American investors.

The European Federation for Retirement Provision is comprised of the private pension funds of the nations of Western Europe. As you can see from the statement, these non-profit institutions are requesting the same tax exempt status granted U.S. non-profit pension funds invested in this country and abroad.

Thank you for your attention to this request.

Sincerely,

ROBERT WM. SMITH, *Partner.*

Enclosure.

STATEMENT OF G.O.J. VAN TETS, EUROPEAN FEDERATION FOR RETIREMENT PROVISION

The European Federation for Retirement Provision is a federation of the national associations of private pension funds in a number of European countries. Private pension funds investing substantially in the U.S. exist primarily in the U.K. and the Netherlands, and to a lesser extent in Ireland and Belgium. In these countries there is wide scope for more investments of this nature if certain market and regulatory conditions are fulfilled.

The withholding tax on interest which your committee at present, in particular, has under consideration is no matter of concern to these institutions, as it is dealt with satisfactorily (waived) under various tax treaties with the U.S., but what does remain is withholding tax on dividends and on real estate income, as well as the ramifications of the FIRPTA-legislation and all its complications and especially the levy of capital gain tax on real estate and other direct investments.

We are, therefore, much surprised that action is proposed by Congress in a field which is already dealt with in the treaties with the major investing countries and which will therefore, have effect especially for investors operating through tax havens, while no relief is given to bonafide institutions who are tax exempt in their own countries on a similar basis as in your domestic regulations such as pension funds and charitable institutions.

Pension funds are tax exempt in their own countries in practically all civilized parts of the world.

Pension funds nearly everywhere take an increasing share in capital formation. In certain countries, such as the U.K. and the Netherlands, they account for the only part of national savings which shows a strong and consistent growth.

When pension funds invest their assets they contribute to the workings of the capital and money markets. Since these are strongly interlinked internationally, it is logical for pension funds also to have an international outlook when their size grows beyond a certain point.

Recognized as tax exempt institutions in their own country because of their social purpose and non-profit character, these funds—and their trustees even more than their professional managers—necessarily balk at being subjected to tax when investing abroad, especially as the countries in which they invest, themselves recognize their own pension funds as eligible for tax exemption on exactly the same grounds on which their own tax exemption is based.

In the last few years pension funds considering further investments in the U.S. were greatly heartened by the introduction in Congress of various bills aimed at dealing with this matter, because whatever the final provisions of any legislation to be forthcoming, it shows the idea that bonafide pension plans ought not to be encumbered by national frontiers in their investment in the capital markets of the world appears to be recognized by the legislators of the country where, by far, the most important of these markets is situated.

However, under the Carter Administration near the end of its term new legislation (FIRPTA) was enacted in the field of real estate investments which, on the contrary, makes life more difficult for investors in the U.S. in that field because that legislation not only is aimed at foreigners, it also hits foreign pension funds as much as any other foreigner. This means that what was inserted in this bill during its consideration by the Congress now threatens to adversely affect institutions such as pension funds, where the ultimate beneficiary does have a rightful claim to more lenient tax treatment and where he is put in a position of the good who have to suffer with the bad.

It is, therefore, now even more important for these pension funds that they be fully exempted from tax as a social and nonprofit institution, whereby the remaining withholding tax on dividends under the various treaties (often 15 percent), and tax on the income from real estate and on capital gains on real estate are removed. Although it is sometimes possible for these institutions to avoid some of this taxation, they rather strongly and emotionally feel tnat it ought not to be necessary for them to have to set up special structures to achieve this aim.

Now two ways appear to exist to deal with this problem: (a) through the revision of existing tax treaties, and (b) through legislative action.

It is feared that the first approach could get bogged down again, as a result of the quid pro quo in the lengthy treaty negotiations involved on the one hand, and the lack of push for the results desired by the pension funds on the part of the various governments involved in such negotiations on the other.

The point which we would like to make is, therefore, that if the Treasury wants to deal with the question by treaty, let them deal with it. In fact, at present, insofar as negotiations are going on there would appear to be a certain amount of stalling and jockeying for position, as a result of which no progress is made. It would, therefore, be helpful if the Congress would indicate that it would want to consider legislation in this field if the matter cannot be resolved quickly and adequately by treaty.

It is obvious that the benefits to the pension fund would be: (a) to remove a major obstacle to investments which appear promising for the fund to achieve its social aims; (b) to achieve greater flexibility for its decisions and very simply to be relieved of a tax burden to which it feels it should not be subjected.

But it also appears that it would be in the interest of the U.S. to achieve these results.

First, to quote a sentence heard on Capitol Hill during earlier discussions: "If there is anything that will contribute to capital formation, if there is anything which will bring money into the country that will go 100% straight into investment and cost hardly any revenue to the budget, this is it." In short taxation is the valve which controls the international flow of capital.

Second, it is preferable to reduce existent tax barriers to such investment which maintain high rates of interest to the detriment of the U.S. economy, cost more in debt servicing, and create tension with America's trading partners, the rest of the world.

Third, as stressed in the quotation mentioned above, the money coming in, in this way, is neither speculative nor consumption oriented. It is fully aimed at long term investment subject, of course, to the normal fluctuations in the stream of such investments depending upon market conditions.

Fourth, the reciprocity in tax matters, if dealt with by treaty, would relieve U.S. pension funds from taxation on investments in European holdings.

Last, from a political point of view, easing of these restrictions would enhance the cohesiveness of the Western economies and would promote the proper functioning of free enterprise economies, where social institutions such as pension funds assume an increasingly important role.

To sum up: taxation is the single most powerful barrier to a free flow of investment funds across the exchanges of the world for institutions which have a tax exempt status in their own country and strongly feel that is rightly so. For an individual or a corporation who is liable to tax in the normal course of his financial dispositions, it does not matter very much whether he is taxed in country A or in country B. His only interest is that he is not taxed twice. Treaties on double taxation deal with this problem. For pension funds and similar tax exempt institutions, however, the mere intricacies of these treaties and their operation in practice are a deterrent. These institutions fully appreciate that it is necessary for their good faith as funds entitled to preferential treatment to be established clearly and beyond doubt. Once this has happened, however, it is their position they ought to be able to judge an investment on its own merits without either the red tape or the burden of paying, avoiding, or recouping taxes. The U.S. as the world's largest capital market—the market also best equipped to deal with capital flows of institutional size—holds many attractions to pension fund investors, from a point of view of both political stability and a free enterprise economy. Elimination of existing tax barriers should greatly help them in achieving the goals of providing proper pensions which they have set for themselves.

GILLETTE CO.,
Boston, MA, March 28, 1984.

Re proposed legislation on Eurobonds and withholding taxes.

JOHN J. SALMON, Esq.,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, DC.

DEAR MR. SALMON: Although I will be unable to testify on the proposed legislation, I would like to add my endorsement to the views that will be expressed by Morgan Guaranty Trust Company of New York and the First Boston Corporation.

The position engendered by the Barnard approach (H.R. 4029) would, in my opinion, serve the best interests of the U.S. Government and the U.S. Corporate community alike.

Very truly yours,

MILTON L. GLASS,
Vice President and Treasurer.

MERRILL LYNCH & CO. INC.,
Washington, DC, April 17, 1984.

Hon. DAN ROSTENKOWSKI,
House of Representatives, Rayburn House Office Building, Washington, DC.

DEAR CHAIRMAN ROSTENKOWSKI: I am writing you to express our concern about Section 141 of H.R. 4170 and to urge total repeal of the 30% withholding tax for foreign portfolio investors. Because of the 30% withholding tax on interest, access by U.S. corporations to the Eurodollar market has been available only through Netherlands Antilles finance subsidiaries. The use of such subsidiaries triggers an annual Netherlands Antilles income tax, which, expressed as a percentage of the Eurodollar borrowing, ranges from .54 percent to more than one percent. Section 141 of H.R. 4170 will disallow a foreign tax credit for these income taxes in the usual case where all of a subsidiary's assets are loans to the U.S. parent and other U.S. affiliates.

The effect of the increased cost of issuing obligations in the Eurodollar market will be to eliminate all or substantially all of the savings resulting from borrowing in that market. Repeal of the 30% withholding tax would make it unnecessary for U.S. corporations to go through the expense of setting up Netherlands Antilles finance subsidiaries. More importantly, repeal would enhance U.S business access to overseas capital markets, lower domestic interest rates and encourage domestic growth and employment. Total repeal would also increase demand by foreign investors for U.S. Government securities, which would assist financing the deficit.

I urge you to support this import change, which has been proposed by Senators Chafee and Bentsen and supported by Representatives Gibbons and Conable and the treasury for this year's tax bill.

Sincerely,

LLOYD J. DERRICKSON,
Vice President.

MORTGAGE BANKERS ASSOCIATION OF AMERICA,
Washington, DC, April 3, 1984.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: In connection with hearings scheduled for April 11, 1984 on proposals to exempt from U.S. tax interest paid to foreign persons, the Mortgage Bankers Association of America wishes to express its support for HR 3025, or other legislation that would repeal the tax.

MBA is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership is comprised of mortgage originators, mortgage investors, and a variety of industry related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios.

On behalf of MBA, I urge prompt passage of HR 3025, which would exempt certain interest paid to foreign individuals and corporations from withholding taxes. The provisions of the bill that call for the repeal of the 30 percent withholding tax that foreign investors must pay on U.S. investments could have a most beneficial impact on the housing and mortgage finance industries of this country through the secondary market operations of the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation, (FHLMC), and the Government National Mortgage Association (GNMA).

Access to foreign capital for FNMA, FHLMC, and issuers of GNMA guaranteed mortgage-backed securities could be most advantageous to the mortgage credit situation in this country. There has been increasing interest on the part of foreign markets in U.S. investment, but the 30 percent withholding tax hampers the U.S. borrower abroad because of the disadvantageous effective yield. As it stands now, the foreign investor faced with buying debt instruments and other securities subject to the withholding tax will simply turn to investments free of the tax.

On September 21, 1983, MBA wrote to you requesting that you schedule HR 3025 for Committee action. MBA appreciates your scheduling hearings on the bill, and hopes that the hearings will lead ultimately to Congressional passage.

We respectfully request that this statement be included as part of the record of the April 11, 1984 hearings.

Sincerely,

DR. MARK J. RIEDY,
Executive Vice President.

NATIONAL ASSOCIATION OF HOME BUILDERS,
Washington, DC, May 1, 1984.

Hon. DAN ROSTENKOWSKI,
Chairman, Ways and Means Committee, House of Representatives, Washington, DC.

DEAR CHAIRMAN ROSTENKOWSKI: On Behalf of the 122,000 members of the National Association of Home Builders (NAHB), I would like to express our support for legislation to phase-out or eliminate the 30 percent tax on interest received by foreign investors from certain types of United States investments.

In recent years the housing industry has sought new sources of mortgage credit in the capital markets. Although the recent development of mortgage related investments have supplied needed funds to housing, we estimate that existing residential sources of credit will have to be supplemented. Throughout this decade, we face unprecedentedly strong demographic demand for housing and hence mortgage credit, as the baby boom generation seeks to realize the American dream of homeownership. If we are to meet this demand for housing, full access to the capital markets is essential.

NAHB has supported legislation to exempt from taxation those foreign pension funds which invest in mortgages originated in the United States. Although complete elimination of the tax is beyond the scope of our curent policy, we generally support additional sources of capital which may be used for mortgages and investment in housing in the United States.

We encourage the Committee to report legislation to allow equitable access by all segments of the United States economy to overseas capital markets. We commend you for scheduling these hearings and we encourage your support of this important legislation.

We respectfully request that this letter be included in the hearing record.

Sincerely,

Peter D. Herder,
President.

STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS

SUMMARY

The National Association of Realtors, representing over 600,000 members in all aspects of the real estate industry, supports legislation which would repeal the 30% withholding tax on portfolio debt instruments sold to foreign investors. Such legislation would usefully expand the scope for U.S. mortgage lenders to borrow internationally to supplement scarce and costly domestic sources of mortgage finance.

The two bills pending which would implement withholding repeal are Representative Gibbons' H.R. 3025 and Representative Barnard's H.R. 4029. H.R. 3025 would repeal the 30% withholding on all portfolio debt instruments sold in foreign investors, H.R. 4029 limits the repeal to bearer Eurobond issues.

Passage of either of these bills would increase the supply of mortgage money available to U.S. homebuyers and help to reduce mortgage rates. However, due to its broader scope, H.R. 3025 would have a greater positive impact than H.R. 4029. Consequently, the National Association of Realtors strongly urges the passage of H.R. 3025.

THE DEMAND FOR MORTGAGE CREDIT IN THE 1980'S

Adequate and affordable supplies of mortgage finance are essential for a healthy real estate industry and sustained economic growth. Between now and 1990, about $1.7 trillion in additional mortgage funds will be required to finance acquisitions of all types of property. To meet this enormous challenge, new sources of mortgage finance must be developed, both inside and outside the country.

Competition for domestic supplies of long-term capital has clearly intensified in the last five years, however. During this period, Treasury borrowing has risen from 34% to 46% of total domestic long-term debt issues, corporate borrowing has declined from 15% to 12%, and borrowing by quasi-governmental agencies, such as FNMA, FHLMC, and the Federal Home Loan Banks, from 23% to 14%. This fall is partly due to the "crowding-out" effect of higher government borrowing.

NEED FOR INTERNATIONAL BORROWING

Increased competition for funds and higher long-term interest rates in the domestic market, coupled with the inducement of lower interest rates on some foreign capital markets, have led U.S. corporations to borrow a significant and generally increasing proportion of their long-term funds overseas (see Table 1).

TABLE 1.—SOURCES OF FINANCE FOR U.S. CORPORATE BORROWERS

[In billions of dollars]

	International borrowing	Domestic borrowing	International as percent of total
1980	4.4	41.6	10
1981	6.8	38.1	15
1982	14.6	43.8	25
1983	7.5	47.3	14

Source: Morgan Guaranty Trust Co.

Meanwhile, U.S. mortgage lenders have been denied competitive access to this important international source of funds. This has resulted in higher mortgage interest rates, fewer real estate transactions, and prevented more people in this country from owning their own home.

The scale of additional borrowing and the interest rate savings that U.S. mortgage lenders could achieve from competitive access to international markets will depend on the types of debt instrument offered, the level of international interest rates and expectations as to the future value of the U.S. dollar.

Interest rate differentials between the major national capital markets are considerable and persistent (see Table 2). Although to some extent offset by the cost of hedging, these differentials nevertheless provide considerable scope for interest rate savings by international lenders.

TABLE 2.—COMPARATIVE BOND YIELDS ON LONG TERM DEBT ISSUES

[Percent]

	December 1980	December 1983
France	14.3	14.0
United States	11.5	12.0
United Kingdom	13.1	9.9
Netherlands	10.5	8.6
West Germany	9.2	8.4
Japan	9.0	7.2
Switzerland	4.6	4.5

Source: Morgan Guaranty Trust Co.

Given direct access to the international capital market, U.S. mortgage lending institutions have calculated that, on average, they could borrow at between 50 and 150 basis points less than on the domestic market. This potential interest saving and the scale of recent U.S. international borrowing suggest the potential for raising mortgage funds internationally is very considerable, even relative to the enormous size of future mortgage finance requirements.

IMPEDIMENTS TO INTERNATIONAL BORROWING BY U.S. MORTGAGE LENDERS

The major impendiment to international borrowing by U.S. mortgage lenders is the 30 percent U.S. withholding tax imposed on interest payments to foreign investors. Most other countries do not require withholding on international bond issues, which places U.S. borrowers at a severe competitive disadvantage when borrowing directly on the international bond market.

To overcome this disadvantage, many large U.S. corporations have made extensive use of international finance subsidiaries located in countries such as the Netherlands Antilles, with which the U.S. has tax treaties that eliminate or substantially reduce the 30 percent withholding tax.

However, U.S. mortgage lenders have not been able to take advantage of this opportunity for international borrowing because:

substantial costs are incurred in establishing and operating an international finance subsidiary;

there is doubt about the legality of offshore borrowing activities;

at least one quasigovernmental secondary mortgage lender has been denied permission to borrow internationally via the Netherlands Antilles.

The offshore borrowing route is therefore not a cost-effective nor reliable solution to U.S. mortgage lenders' need for competitive access to the international capital market. An alternative and better solution must be found.

POSITIVE ECONOMIC IMPACT

By eliminating tax withholding, the enactment of H.R. 3025 would substantially increase the potential supply of mortgage finance in the United States and help to reduce mortgage interest rates. These lower interest rates would make home ownership possible for a substantially larger number of families, spur the housing recovery, and offer jobs, and create additional investment opportunities.

COMPANION LEGISLATION

Senator Chafee (R-RI) has introduced legislation similar to H.R. 3025 in the Senate (S. 1557). A modified version of this bill is included in the Senate Deficit Reduction Act of 1984. As it now stands, the Senate proposal would reduce the withholding to 5 percent in 1984 and phase it out progressively in annual 1 percent increments, leading to total elimination in 1988.

The purpose of this phased elimination is to moderate its impact on the economy of the Netherlands Antilles. However, it would postpone competitive access to international capital markets by U.S. mortgage lenders for several years, artificially reduce the supply of mortgage credit and raise its cost. At this time, when interest rates are again starting to climb, it is our view that the positive economic impact of immediate repeal should take priority over this other concern.

FEDERAL BUDGET IMPLICATIONS

In addition to providing access to the international capital market, the removal of interest withholding would obviate the need for U.S. corporations to establish finance subsidiaries in the Netherlands Antilles in order to compete effectively for international funds. It would thereby reduce and perhaps eliminate the payment of tax credits to U.S. corporations presently registered in the Netherlands Antilles and bring U.S. corporate activity in the international bond market under effective jurisdiction of the U.S. tax authorities. Consequently, both H.R. 3025 and H.R. 4029 would increase tax revenue and reduce current and prospective federal budget deficits, thus helping to moderate domestic interest rates.

CONCLUSION

The economic benefits of the removal of the 30 percent withholding on foreign portfolio investment are substantial. The increased availability of mortgage finance would not only lower interest rates and encourage home ownership, but also create jobs and help to sustain the economic recovery. The broader the scope offered for international lending, the greater the positive economic impact will be.

Further, although there are sound political reasons for the Senate's proposed phased elimination, we believe that the positive economic impact of complete and immediate withdrawal justifies such action. Therefore the National Association of Realtors urges the Committee to adopt H.R. 3025 in lieu of the current Senate provision in the forthcoming conference.

STATEMENT OF THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

The National Council of Savings Institutions is pleased to express its support for the legislation—H.R. 3025 and H.R. 4029—which would repeal the 30 percent withholding tax currently imposed on payments by U.S. persons to foreign investors. We applaud the sponsors of H.R. 3025 and H.R. 4029 for recognizing the need to reduce barriers to the free flow of investment and capital from abroad that has contributed so greatly to the growth of the U.S. economy. We also commend the Chairman for timely scheduling of Committee hearings on these significant proposals.

The National Council supports this legislation because we believe that the Eurodollar market offers opportunities to our thrift institution members for additional sources of capital at favorable interests rates. This is very important as these institutions restructure and recapitalize after the turbulent economic situation of 1980–1982.

In addition, access to the Eurodollar market provides a supplemental resource for meeting the housing credit needs of the future. Given the growth in demand for housing credit anticipated in the remainder of this decade and the borrowing needs of the federal government to finance the deficit, it is likely that a supplemental resource to the U.S. capital market will be necessary if thrift institutions are to continue their primary role as housing lenders. The rapid growth of the secondary mortgage market requires that thrift institutions and other entities such as the Federal National Mortgage Association be able to tap the considerable funds available from foreign investors. The intermediate and long-term maturities available in the Eurodollar market are well suited to match the maturities of mortgage instruments, making this a logical source of funds.

Unfortunately, the ability to tap this source of funds through the use of securities is hindered by the current law requiring 30 percent tax withholding on the interest paid on these securities. It is either necessary to increase the rate paid to these investors (thereby negating the use of the Eurodollar market to gain favorable rates) or to access the market through an offshore subsidiary such as a Netherland-Antilles subsidiary (adding additional cost and complexity) if foreign investors will buy securities. Removal of the 30 percent withholding would remove these barriers and allow direct access by entities desiring to use the Eurodollar market as an additional source of funds without the necessity of structuring an offering as a deposit to meet the exemption provided for banks and thrifts in Sec. 861 of the Internal Revenue Code.

Banks and thrift institutions currently enjoy an exemption from the 30 percent withholding under Internal Revenue Code Sec. 861(a) and 861(c) on interest paid on deposits, this exemption, however, does not include interest paid on securities such as mortgage-backed securities.

While the direct access is important to a number of corporate borrowers, it is imperative if *federal* savings and loans and *federal* savings banks are toaccess the market, since these entities appear to be forbidden by regulation from using an offshore subsidiary. Unless the barriers to direct access are eliminated, these institutions are effectively foreclosed from tapping this source of funds.

There is an additional problem that must be remedied if the legislation is to accomplish the designated purpose. This is the problem created by the Treasury Department regulations on backup withholding, which require certification by the individual investor that he or she is not a U.S. citizen. Foreign investors have been reluctant to provide such certification because of fear that the U.S. tax authorities will gain access to the individual names. Further, participating European banks have concerns that such certification may, if accessible by U.S. tax authorities, violate their own countries' bank secrecy laws.

While one can debate the merits of these concerns, the fact is that unless the problem is resolved, it will be difficult—if not impossible—to successfully compleste Eurodollar offerings. A case in point is a recent CD offering by Northeast Savings, FA, which was actually in syndication. The Northeast offering had been priced and effectively sold when participating European banks were informed by counsel that the certification requirement and the *possible* acquisition of these certificates by the Internal Revenue Service would violate their domestic bank secrecy laws. Therefore, the European banks did not believe they should finalize the deal and the offering had to be withdrawn.

While this particular offering was structured as a deposit to meet the current exemption from the 30 percent withholding for interest from banks and thrift institutions, the same problem could arise with offerings structured in other forms, due to the backup withholding certification requirements. This problem must be eliminated and we suggest that the Committee direct the Treasury Department to amend the regulations to eliminate such certification in Eurodollar offerings which are structured to be sold only to foreign investors.

The Council appreciates the opportunity to comment on this important legislation. We urge the Committee to act promptly to favorably report this legislation.

PATTON, BOGGS & BLOW,
Washington, DC, May 11, 1984.

Re repeal of 30 percent withholding tax—Netherlands Antilles.

Mr. JOHN J. SALMON,
Chief Counsel (Majority), Committee on Ways and Means, Longworth House Office Building, Washington, DC.

DEAR JOHN: Enclosed is a paper regarding the interaction between the proposed repeal of the 30% withholding tax and the need for clarification of present law with respect to finance subsidiaries under the Netherlands Antilles treaty.

Obviously, it is correct to repeal the withholding tax and to allow full direct access to the foreign lending market. This will take a lot of pressure off "crowding out" in the domestic financial market.

Our primary concern is in getting a clear-cut clarification of present law on indirect access to the Eurobond market through a Netherlands Antilles finance subsidiary. Since 1974 when the IRS stopped issuing five-to-one debt equity ratio rulings, most companies have set up N.V. finance subsidiaries in standard form using a more conservative debt to equity ratio than the IRS had required. During all these years, the IRS has been fully aware of that and has not challenged these mainstream arrangements which clearly are contemplated by the existing treaty. Yet, recently for some inexplicable reason (perhaps related to treaty negotiations) the IRS has begun to challenge N.V. finance subsidiaries on a somewhat random basis.

Specifically, our concerns are twofold. First, if the IRS continues the attack for past years on N.V. finance subsidiaries which have provided indirect access to the Eurobond market, and if Congress repeals the tax in 1984 for the policy goal of providing direct access to the Eurobond market, we will have the worst kind of inconsistent policy over time and among similarly situated taxpayers—a period of permitted indirect access up to 1974 under IRS rulings, a period from 1974 to 1984 when indirect access is denied inconsistently and randomly by what amounts to a retroactive policy change by IRS, and a period from 1984 forward when direct access is allowed by congressionally enacted and Treasury supported policy.

Second, if the witholding tax is retained for several years under phase-out as in the Senate bill, it is also necessary to have a clear-cut clarification of present law on N.V. subsidiaries. Presumably, the only reason for phasing out the withholding tax (instead of immediate repeal) is to avoid an immediate impact on the Netherlands Antilles—which necessarily means that during the phase-out period (while there is still a withholding tax of 5%, 4%, 3%, etc.) Congress intends that corporations will still be able to use N.V. subsidiaries to gain a zero withholding rate as under present law. Otherwise, the phase-out would be a meaningless gesture to the Netherlands Antilles and would serve only to continue to deny both indirect and direct access to the Eurobond market. Thus, in all events present law must be clarified.

Our suggestion is that the Conferees ask for and obtain a commitment from Treasury, to be reflected in the Conference Report, that for past years and for years going forward into a phase-out, the standard form of N.V. subsidiary arrangement with a debt to equity ratio of no more than four-to-one will be recognized as within a type of "safe harbor."

Sincerely,

ERNEST S. CHRISTIAN, Jr.

Enclosure.

NEED FOR CONSISTENT POLICY ON ACCESS TO EUROBOND MARKET

Summary.—Present law, which generally imposes a 30 percent withholding tax on interest payments by U.S. corporations to foreign lenders, has effectively precluded U.S. corporations from gaining *direct* access to the Eurobond market. U.S. corporations have long gained *indirect* access to that market by using finance subsidiaries established in the Netherlands Antilles which has a tax treaty with the U.S. that eliminates the 30 percent withholding tax. The Senate tax bill provides for the phased repeal of the 30 percent withholding tax. Pending legislation in the House provides for outright repeal of the 30 percent withholding tax. Both the Senate tax bill and the House proposals would thus provide *direct* access to the Eurobond market and eliminate the need for *indirect* access through financing subsidiaries in the Netherlands Antilles.

Whether or not Congress adopts legislation to repeal the withholding tax for the future, the existing law treatment of finance subsidiaries should be clarified to assure that the tax laws and policies (1) are consistently applied over time and among similarly situated taxpayers, and (2) are compatible with Treasury policy to promote access by U.S. corporations to the Eurobond market.

Discussion.—The use of finance subsidiaries to gain indirect access to the Eurobond market without imposition of the withholding tax is contemplated by the existing tax treaty between the U.S. and the Netherlands Antilles, and was originally sanctioned by the IRS in advance rulings. Since 1974 when the IRS discontinued issuance of advance rulings on the establishment of finance subsidiaries, most U.S. corporations have relied upon opinion of legal counsel that finance subsidiaries would be recognized for U.S. tax purposes. Typically, these opinions applied more strict standards (e.g., lower debt to equity ratios) than the IRS had previously used for advance rulings purposes. Of course, U.S. corporations have and continue to comply with the pertinent terms of the U.S. tax treaty with the Netherlands Antilles.

Thus, the IRS has for many years been aware of the use of finance subsidiaries and the way these subsidiaries were being structured. During all those years, the IRS never publicly announced that finance subsidiaries structured in the form used by most U.S. corporations would not be recognized for U.S. tax purposes. Nevertheless, recently corporations have become aware that the IRS has taken that position and has begun to challenge finance subsidiaries, apparently on a random basis, in audits of many U.S. corporations. These essentially policy-oriented actions of the IRS threaten the viability of continued access to the Eurobond market, notwithstanding the clear Treasury policy to promote such access through repeal of the 30 percent withholding tax.

If Congress repeals the withholding tax, the IRS audit policy, if not abandoned, will effectively create a "window" period during which access to the Eurobond market may be disallowed on a selective basis even though such access was allowed by administrative action for pre-window periods and will be allowed by Congressional action for the post-window period. This result—inconsistent tax policy over time and among similarly situated taxpayers—is both inappropriate and inconsistent with the fundamental premise of repeal legislation. Congress must, therefore, clarify existing law with respect to finance subsidiaries.

If Congress decides to retain rather than repeal the withholding tax, or decides to retain the withholding tax for a period of time as under the Senate's phase-out approach, it also must clarify existing law with respect to finance subsidiaries. A principal, and perhaps the only, policy justification for retaining any withholding tax as applied to U.S. corporations is to avoid the impact of total and immediate repeal on the economy of the Netherlands Antilles. Thus, by retaining the withholding tax, Congress will implicitly sanction the continued use of finance subsidiaries. Without the use of such subsidiaries, the retention of the tax (even on a phase-out basis) will be a meaningless gesture to the Netherlands Antilles and a severe blow to the ability of U.S. corporations to gain access to the Eurobond market.

Proposal.—As part of any legislation to repeal the withholding tax (whether such repeal is effective immediately or on a phased basis), Congress should obtain a commitment from the Treasury, to be reflected in the Conference Report, that IRS tax audit positions with respect to finance subsidiaries will be consistent with the policy of access to the Eurobond market and with the widespread practices of most corporations in the past. Specifically, finance subsidiaries should be sanctioned by Congress for the "window" period (i.e., all prior years and all future years before repeal is completely effective) where the subsidiary maintained a debt to equity ratio of not more than four to one.

In addition, so long as any vestige of the 30 percent withholding tax continues to apply to U.S. corporations, the provisions of the House and Senate tax bills limiting the ability to U.S. corporations to claim foreign tax credits based upon the income of their Netherlands Antilles finance subsidiaries should be postponed pending renegotiation of a new tax treaty with the Netherlands Antilles. At a minimum, however, these rules should be modified so as *not* to apply to any future payments of interest on any pre-existing indebtedness (i.e., debt originally issued before April 1, 1984).

If the withholding tax is not repealed (either immediately or on a phase-out basis), then Congress should nevertheless provide a safe harbor as outlined above. Otherwise, continuation of the tax will serve no purpose but to deny U.S. corporations access to the Eurobond market.

R.J. REYNOLDS INDUSTRIES, INC.,
Winston-Salem, NC, April 13, 1984.

Mr. JOHN J. SALMON,
Chief Counsel, Ways and Means Committee, Longworth House Office Building, Washington, DC.

DEAR MR. SALMON: R.J. Reynolds Industries, Inc. is a premier, worldwide consumer goods company marketing tobacco products, wines and spirits, fresh fruit and grocery products in virtually every country of the world. Its major operating subsidiaries include R.J. Reynolds Tobacco Company, Del Monte Corporation, Heublein, Inc. and Kentucky Fried Chicken. It also owns Aminoil Inc., the second largest independent petroleum exploration and production company in the U.S. Reynolds' 1983 worldwide sales exceeded $13.5 billion.

R.J. Reynolds Industries, Inc. has periodically borrowed on the Eurobond market to provide the lowest cost financing available for both its domestic and foreign operations. Like other major Eurobond borrowers, Reynolds has utilized a Netherlands Antilles finance company which borrows on the Eurobond market and then lends to its U.S. parent. Its most recent Eurobond borrowing was in January of 1984.

We therefore welcome the opportunity to comment in favor of the repeal of the existing 30% withholding tax on interest paid by U.S. corporations to foreign lenders. Such a repeal is required if U.S. corporations are to continue to access the Eurobond market, due to the proposals to recharacterize foreign source income contained in Secs. 140–142 of the supplement to HR 4170. These proposals, which would classify distributions received from Netherlands Antilles finance companies as U.S. source income, instead of foreign source income, will prevent Reynolds and other companies from claiming the substantial Netherlands Antilles income taxes incurred (approximately 30%) as a foreign tax credit. Denial of the Netherlands Antilles income tax as a foreign tax credit will add at least 150 basis points (1.5%) to the ultimate interest rate of a typical Eurobond issue. Such an increase would result in making Eurobond borrowings noncompetitive vis-a-vis U.S. borrowings since the favorable interest rate differential offered by Eurobonds, from time to time in the market, typically does not exceed .5%. Thus U.S. companies, as a practice, would effectively be locked out of the Eurobond market. The net result of such legislation will be to shift Eurobond borrowings (estimated at $8–12 billion annually) to domestic capital markets which would undoubtedly produce adverse effects on U.S. interest rates.

The Senate Finance Committee's proposal to immediately reduce the withholding tax to 5%, and then progressively to zero by July, 1988 is not an adequate remedy to the problem posed by the above mentioned legislation. Loan costs will still be raised to a point where they may still severely reduce or eliminate the interest rate differential for several years. More importantly, the presence of any withholding tax will impose sufficient administrative burdens and complications to dissuade the majority of potential borrowers from utilizing the Eurobond market as a source of funds.

If American corporations are to continue to access the Eurobond market, without a 4–5 year hiatus, there must be a complete and immediate repeal of the 30% withholding tax. In addition, we would recommend that the repeal of the 30% withholding tax be limited to interest paid by U.S. corporations to foreign lenders. If the exemption from withholding taxes is extended to U.S. government issues, we are concerned that the resulting competition between U.S. government and corporate borrowings would reduce and, in some cases, eliminate any potential interest rate differential so as to render the Eurobond market unattractive to at least some, if not all, corporate borrowers.

Thank you for this opportunity to comment in favor of the total elimination of the 30% withholding tax on interest paid by U.S. corporations to foreign borrowers.

Yours truly,

GWAIN H. GILLESPIE,
Senior Vice President and Chief Financial Officer.

STATEMENT OF W. DEAN HUDSON, VICE PRESIDENT IN CHARGE OF TAXES, SOUTHERN COMPANY SERVICES, INC.

My name is Dean Hudson and I am Vice President in charge of taxes for the Southern Company and Subsidiaries. My business address is: Southern Company Services, Inc., 64 Perimeter Center East, Atlanta, Georgia 30346 (telephone number 404–399–3549). I appreciate the opportunity to present this statement on behalf of the Southern Company and Subsidiaries.

The Southern Company is the parent firm of four electric utilities in the Southeast: Alabama Power Company, Georgia Power Company, Gulf Power Company, and Mississippi Power Company (herein collectively referred to as the Southern electric system). The Southern electric system operates 236 generating units with a total capacity of 24,840,281 kilowatts. An additional 5.8 million kilowatts of capacity are under construction. These facilities are interconnected by approximately 25,000 miles of transmission lines across a service area which spans parts of four states: Most of Alabama and Georgia, the panhandle of Florida, and 23 counties in southeastern Mississippi. The Southern electric system provides electricity directly and indirectly to approximately ten million people in the Southeast.

The Southern electric system supports legislation, H.R. 3025 and H.R. 4029, which wuld repeal the 30-percent withholding tax on interest paid to foreign investors. Such legislative proposals are important to the Southern electric system. Our needs for raising capital through the sales of bonds are expected to total more than $2.2 billion dollars during the next five years. The proposals to exempt from U.S. tax interest paid to foreign persons would facilitate access to foreign capital markets. Access to foreign capital markets would provide an important alternative source of capital which would help to insure adequate electrical service for the expanding economy of the Southeast.

Uncomplicated access to foreign capital market is needed and would be meaningful to the Southern electric system and beneficial to its customers. My associates and I urge the Committee on Ways and Means to take favorable action on proposals such as H.R. 3025 and H.R. 4029

TRIBUNE CO.,
Chicago, IL, April 26, 1984.

Hon. DAN ROSTENKOWSKI,
House of Representatives, Rayburn House Office Building, Washington, DC.

DEAR CONGRESSMAN ROSTENKOWSKI: I am writing to express Tribune Company's concerns regarding a tax issue of importance not only to us, but also to the U.S. economy as a whole. We urge you, and the Committee on Ways and Means, to preserve American corporations' access to financing in the Eurobond market. The provisions of H.R. 4170 and the amendment to H.R. 2163 passed by the Senate threaten to close off this market as a source of financing to the private sector in this country.

The federal budget deficit has forced the Treasury to draw on the credit markets at a record rate, exerting upward pressure on interest rates. In this environment, American corporations must have access to financing at reasonable rates to maintain a healthy national economy.

Eurobond financing is an important source of capital to American businesses for expansion and investment at competitive rates. In 1981, for example, Tribune Company borrowed $50 million in the Eurobond market to finance, among other things, construction of the Chicago Tribune's state-of-the-art Freedom Center production facility in Chicago. We have just completed a $25 million loan transaction, at favorable rates, through Tribune Company's Netherlands Antilles subsidiary, for use in our broadcasting and entertainment activities.

Despite the costs of establishing a Netherlands Antilles Subsidiary, Eurobond financing typically saves 25 to 75 basis points on an issue's coupon. This saving may mean the difference between investing and expanding now, or deferring investments until rates become more favorable.

We urge that you and the other representatives of the Committee on Ways and Means give serious consideration to H.R. 4029, sponsored by Rep. Barnard of Georgia, in arriving at the conference agreement on the final provisions of the Tax Reform Act of 1984. This measure offers the greatest advantages to the American economy as a whole, and is superior to the bills adopted by the House and Senate.

We favor the bill for these reasons:

1. H.R. 4029 would preserve access to the Eurobond market for American corporations.—The Senate's proposal to phase out the withholding tax on interest paid to foreign lenders, if implemented, would immediately end the usefulness of Eurobond financing, because lenders would insist on premium interest rates to compensate for the withholding. Moreover, in 1988, when the "phase-out" would be complete, the U.S. Treasury would be able to borrow from foreign sources on an equal footing with corporate borrowers. This could lock U.S. corporations out of the Eurobond market as effectively as a partial withholding tax or an excise tax, since, again, foreign investors would demand a premium from corporate issuers over rates on U.S. Treasury obligations. H.R. 4029 would end the withholding tax in a single stroke, and would tailor the exemption to those who need it—U.S. corporations.

2. H.R. 4029 would bring in substantial revenues to the Treasury.—By eliminating the 30 per cent withholding tax, the bill would immediately end the need to use offshore subsidiaries to obtain access to Eurobond markets. As you know, the Netherlands Antilles taxes these subsidiaries, and the tax payments (estimated at more than $100 million a year) translate into credits against taxes paid to the U.S. government. H.R. 4029 would end this anomalous diversion of tax dollars and help to reduce the federal deficit.

3. H.R. 4029 would simplify tax treaty negotiations with the Netherlands Antilles.—It has been reported that the Netherlands Antilles' secrecy laws are providing shelter for large-scale evasion of U.S. taxes and hindering the enforcement of our criminal laws. By eliminating the need for offshore financing subsidiaries, H.R. 4029 will enable U.S. negotiators to deal with tax and other diplomatic issues on their merits.

For all of these reasons, we recommend adoption of H.R. 4029's provisions. The Senate phasout of withholding and the provisions of both the House and Senate-passed bills which would disallow substantial tax credit and thus increase borrowing costs would impair Eurobond financing almost as effectively as if they prohibited it altogether.

H.R. 3025, the Gibbons-Conable bill, would be equally destructive. It would thrust corporate issuers into competition with the federal Treasury in the Eurobond market—a contest they cannot compete in. We also question why Congress would want to forego the tax-revenue benefits of the 30 per cent withholding provision that would be repealed by H.R. 3025 and the Senate bill, but would be continued in H.R. 4029 as to U.S. Treasury obligations.

Only a few small countries—Holland, Sweden, Norway and Denmark—have no withholding tax on interest paid from any source to foreign lenders. Germany, Japan and France exempt payments to foreign lenders by corporate issuers, as H.R. 4029 would do. We suggest that this is the correct approach.

The current uncertainty as to the outcome of the pending legislation and the inclusion of retroactive effective dates in the House and Senate bills also make it virtually impossible to make informed business judgments on proposed financing at the present time.

We appreciate your interest in our views on this extremely important matter of national economic and tax policy. We request that these comments be included in the record of the Committee's hearings on May 1.

Thank you for your consideration.

Sincerely yours,

JOHN W. MADIGAN,
Executive Vice President.

WARNER-LAMBERT CO.,
Morris Plains, NJ, April 16, 1984.

Re proposed tax legislation withholding tax/foreign lenders S. 1557; H.R. 3025; and H.R. 4029.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, Longworth House Office Building, Washington, DC.

DEAR CONGRESSMAN ROSTENKOWSKI: I would like to register this company's support for elimination of the present withholding tax on interest paid to foreign lenders as espoused by Representative Barnard in H.R. 4029. It would appear that the more narrow Barnard approach, as opposed to the broader approach of Representatives Gibbons and Conable in H.R. 3025, would, in conjunction with other proposals also under consideration, most nearly preserve the status quo of the access of the private sector to the Eurodollar market while eliminating the Treasury revenue loss now associated with the private use of the Netherlands Antilles. I am not in a position to say whether the described combination would result in a net tax gain or loss to the U.S. Treasury, however it would conceptually seem that an increased tax cost to the Treasury would attach to the broader Gibbons-Conable exemption.

I would like to simultaneously register opposition to the phase-out approach endorsed by the Senate Finance Committee in lieu of an immediate reduction of the withholding to zero. On the bais of my personal experience with multinational financing as well as the extensive experience of this corporation, I believe that the phase-out approach, coupled with elimination of the Netherlands Antilles route, would effectively preclude access to the Eurodollar market for U.S. corporations until the zero withholding point was reached. I do not think that result is desirable from any standpoint.

I hope you find these brief comments useful and I thank you for your attention. We will of course be watching the progress of this legislation with great interest and also with the hope that these proposals do not meet the fate of previous proposals on the same issue.

Yours very truly,

George Hromadko,
Vice Chairman of the Board and Chief Financial Officer.

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